The Machinery *of* Wall Street

WHY IT EXISTS, HOW IT WORKS AND WHAT IT ACCOMPLISHES

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CHAPTER I

Why Do We Need a Wall Street?

TO most people the machinery of Wall Street seems intricate and mysterious. There is probably no part of the business activities of the country that is so much misunderstood.

The popular idea of Wall Street, picked up from miscellaneous sources, such as newspaper headlines, cartoons, magazine stories and moving pictures, seems to embrace a hodge-podge of corpulent, side-whiskered bankers surrounded by champagne bottles, haggard speculators bending feverishly over stock tickers, habitually risking their last dollar and generally losing it, Mephisto-like manipulators always determined to ruin each other or be ruined in the attempt, and child-like young gamblers whose touching confidence in human nature leads them to risk their widowed mothers' patrimonies in a single throw on any "tip" which may be offered them.

To the man who is earning his livelihood day

by day in the clock-like, well-ordered, efficient business life of the Street, these popular ideas seem so absurd that he thinks they must be mythical. It is only when he leaves his habitual haunts and mingles with the people on the farms, in the stores and in the factories that he awakes with a start to the monumental ignorance of the public in general about the things that seem to him nothing but daily business routine.

But while the details of the machinery of Wall Street are complicated, just as are the details of the steel industry or boot and shoe manufacturing or any other specialized department of modern life, its main features and purposes are comparatively simple and very interesting.

Why a Wall Street?

Why do we need a Wall Street? For it must be that we do need it or we should not have it. Nothing could call it into existence except a demand of some sort for the services rendered.

To start at the beginning, it is, as all the

economists tell us, division of labor that permits and to a great extent causes the advance of civilization. So long as each individual grows for himself or makes for himself everything that he needs, he is a slow and clumsy producer. He has to do everything on such a small scale that he can make use of no machinery and only of the simplest tools. He has little chance to rise above the standard of living of a savage.

With the division of labor comes a great gain in production, and the gain is constantly increasing through the use of more and better machinery, which only the division of labor permits.

But division of labor means that each man, or each group of men, makes a different product—hence these various products must in some way be exchanged before they can be put to use where they are needed. At first the man who has too many potatoes exchanges some of them with his neighbor, who has too much corn, and so on. But this is a slow and awkward process, and the next step is for all the people who have any exchanging to do to meet together at some agreed place, and do

it all at once—in other words, a **market** is established.

So long as transportation is slow and crude, each community has to have its own little market; but the larger the market the more conveniently the process of exchanging can be carried on, and now that railroads, mails, telegraph and telephone bind whole nations together, it is possible to have sectional, national or even world markets.

There is another thing besides transportation that permits the exchanging process to be centralized for a large area, and that is the intricate network of credit that binds the modern community together. The Dakota farmer, for example, can, by establishing a credit at Chicago, sell his wheat there by telegraph—to be delivered at some future date—and at the same time the New York or Liverpool merchant can buy at Chicago in the same way.

And as the use of credit develops, the credit itself comes to be something to be bought and sold for a certain rate of interest, so that a central market for credit is also needed—the money market, in current phraseology.

Next, large-scale production requires the corporation—because one man would not ordinarily have money enough to finance large-scale production, so that it is necessary for many persons to club together and put up the money. Each member of such a club gets a certificate showing his **share**—as the English logically say—in the ownership of the corporation, and these shares or stocks have to be bought, sold and exchanged somewhere in a central market.

Thus in a perfectly natural and obvious way, to meet the necessities of the modern industrial organization, the money market and the stock exchange arise—or in common parlance, Wall Street.

Wall Street As a Money Market

In the Wall Street district we find the central exchange or market for money, capital, securities, several important commodities, and foreign exchange. All these things may be and constantly are exchanged elsewhere also, but Wall Street affords the principal market for them in this country.

The term "money market" is used to cover

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not only the exchange of actual cash, in gold, silver or currency, but also bank checks (which are merely substitutes for money, made possible by established credit) and short term loans, which involve the payment of money at an early date. Thus call loans—the payment of which may be demanded at any time—or loans for three or six months and occasionally one year, are included in the money market. 33-34

If these short term loans arise out of commercial transactions they appear in the form of notes given by those engaged in various lines of business and are called commercial paper. If the loans are based on mortgages, bonds or stocks as security, they are called collateral loans.

Capital, on the other hand, as used in Wall Street phraseology, refers to funds which are invested in a more permanent way; that is, in some productive enterprise, whether through the medium of securities issued by a corporation, or directly, as in the case of a partnership or individual business.

It will be seen that the distinction between "money"—in the sense of bank deposits, com-

mercial paper, or short term loans—and capital, is not very sharply drawn. We deposit our "money" in the bank; the bank loans it to somebody else as "money"; but a surplus of unloaned deposits in the banks represents a sort of potential capital, because a part of such a surplus is pretty sure to be invested in business enterprises of various kinds. Hence an accumulation of bank deposits is often referred to as "liquid capital," because it is capital in a preliminary form, ready to flow into any business enterprise that its owner may select.

Wall Street carries on the process of exchanging securities in a variety of ways, to suit the convenience of the people who have the work to do. If a stock or bond is being constantly bought and sold in considerable quantities it is more convenient for the brokers who do the work to get together around a post on the floor of the Stock Exchange. If for any reason the Exchange has not admitted a certain security to its list, but there is nevertheless a good deal of trading in it, the brokers who handle it gather in the street outside, forming the Curb market.

Still other securities are bought and sold only occasionally. These are generally classified as "unlisted." Certain brokers specialize in one or more of these inactive securities, being always ready to buy at one price or to sell at a somewhat higher price. Other brokers know who the specialists in different securities are, so that the market for a security is more or less centralized around the specialist.

In this way there arises an "unlisted market," in which brokers get together by telephone or telegraph, instead of gathering in the Stock Exchange or on the Curb.

Symbols of Capital

All these stocks, bonds and mortgages represent capital. They are not capital in themselves because the capital they represent has long ago been paid in and has gone its way into the business of the company which issued the securities, where it can be found in the form of factories, warehouses, land, materials, steel rails, cars and locomotives, bank deposits of the company to be drawn upon as needed, or what not. The stocks and bonds are

merely certificates of ownership or of capital loaned.

New capital is, of course, constantly piling up, as a result of the profits and savings of the people, and as constantly flowing out into new business enterprises or the enlargement of old ones, generally through the medium of securities of some sort.

Even among well-informed persons, few have any adequate idea of the rapidity with which new capital accumulates in this country. In 1916 our wealth is growing at the rate of at least eight per cent. yearly, probably nine per cent., possibly ten per cent.—or say $20,000,000,000 a year.

A part of this increase represents the growth in the appraised value of land, which is a monopoly value, because the land is but little more productive than it was last year; but probably $12,000,000,000 a year is produced wealth which actually goes toward making the people richer. A large part of this wealth is spent for immediate use and enjoyment, but even after that has been deducted there remains a tremendous surplus which is carried forward as new capital every year. For the

distribution of this capital into business enterprise Wall Street is the important central agency.

Investment of Savings

In this way Wall Street affords the principal opportunity for the profitable investment of savings. Savings of a business man are more likely to be called profits, and the savings of a corporation are known as surplus, but the three amount to the same thing.

Savings are sometimes invested directly in securities, but more often indirectly. The wage-earner puts his money in the savings bank and the bank buys bonds with it. The business man allows his profits, perhaps, to accumulate in his checking account at his local bank, but that bank will make profitable use of them in some way—and to earn a profit they must be invested somewhere. The corporation's surplus may go into a New York trust company, which perhaps loans them to a broker on collateral security, while the broker in turn lends the money to a customer who uses it as part payment for stocks. So in one way or another a very large part of the coun-

try's savings pass through Wall Street on their way into productive enterprises.

Since commodities, such as wheat, hay or cotton, are not as easily transported as securities or credit, Wall Street, situated at one end of a country 3,000 miles wide, naturally does not hold the same dominating position in the commodity markets as it does in security markets. There are three important commodity exchanges in New York City, dealing in cotton, coffee and grain. The Produce Exchange is only one of a dozen or so of various sizes in different parts of the country—the largest of which is, of course, the Chicago Board of Trade. The Cotton Exchange shares business in that staple with New Orleans.

These exchanges deal in their respective commodities for future delivery as well as on a cash basis. If cotton could not be bought or sold on the exchange unless the cotton was actually on hand to be deliveed at once, the usefulness of the exchange would be nearly nullified. Now, any one who has or expects to have cotton in any part of the world can buy or sell it at New York for delivery as far ahead as may be necessary. That brings

buyers and sellers on different continents almost as near together as though they were in the same room.

Foreign Exchange

The necessity for a central market in foreign exchange arises from our foreign trade. If A has sold $10,000 worth of cotton to England while B has bought $10,000 worth of pocketknives, there is obviously no sense in A's sending $10,000 in gold across the ocean only to have it sent back again to B. Stripped of all technicalities, the foreign exchange market simply enables B to pay the $10,000 to A, thus closing up both transactions. This could only be done through some sort of central market, as otherwise A and B would never get in touch with each other.

The principal reason why we need a Wall Street, then, is to bring together buyers and sellers, borrowers and lenders, from all over the world. Capital flows through Wall Street into varied industries just as the heart distributes the blood to the different parts of the body. It is like the big central exchange of a telephone system. From it the wires run to all

the people who want to do business in the things with which Wall Street deals. The man who has a few shares of stock to sell or a few thousand dollars to loan is indirectly put in touch with the whole world for a market.

It is a splendid piece of machinery, probably the most valuable to the country of any mechanism or organization the mind of man has devised. It will be well worth our while to examine its parts more in detail.

The Banks—Bank Statement—Clearing House—Sub-Treasury

THE modern bank grew up out of the ancient business of money-changing, or exchanging the money of one country for that of another. That business was always unpopular because the money-changer did not appear to be doing any real work for the profits he made out of the exchange, and because the money-changers often drove unfair bargains with those who were at their mercy.

The Middle Ages did not recognize the legitimacy of interest on borrowed money. It was looked upon as extortion, the economic function of capital being altogether too abstract a conception for the people to assimilate— and that is still true of many untrained minds in every country.

Most of the diatribes against the "Money Power," the "sharks of Wall Street," and so on, are really the off-spring of this ancient prejudice. It is, perhaps, an evidence of the natural selfishness of mankind that the money-

lender has always been hated by the borrower, with or without cause; but the advent of the corporation has done much to remove this prejudice by taking the personal element out of business.

The first bank worthy of the name is supposed to have been established in Venice in 1157. The word bank signified a "pile" or "mass" of funds. The early Italian banks were chiefly for the handling of government obligations. The next step was for the bank to undertake the care of money for individuals and firms, and at a later date for corporations. Money so deposited is always subject to the order of the depositor, either on demand or at a certain date, or after a specified notice.

Interest may or may not be paid on these deposits, according to the agreement; but to pay the cost of handling the money, and the interest, if any, the bank is allowed to lend the deposits out at interest, always keeping in hand a certain amount of cash to meet the current demands of depositors. In this way we arrive at the main items of the modern "bank statement"—deposits, loans and reserves.

Trust Companies are chartered under State laws, and are authorized to do a general banking business, but cannot issue currency, that power being reserved for banks having the National charter. Trust Companies may also undertake almost any kind of trust as their name indicates, and engage in nearly every kind of legitimate business. They are of recent development. The first one was established in New York in 1822, and as late as 1871 there were none in Boston.

Trust Companies at first confined themselves to handling funds left in trust, but as they were not so closely restricted by law as the banks they gradually found themselves able to pay a higher rate of interest on deposits, and hence did more and more a general banking business. In New York they are now almost equal to the banks in importance.

The Bank Statement

All banks—except private bankers—issue public statements of their condition from time to time. The U. S. Comptroller of the Currency calls for such statements from all National Banks about once in two months. The exact

date is not fixed until after it is past, to prevent the banks from making special preparations for the statement.

The banks of several of the big Eastern cities issue statements weekly, for the convenience of the public. Far the most important of these weekly statements is that of the banks and trust companies which are included in the New York Clearing House. It is given out on Saturday, and is printed or summarized in the leading newspapers throughout the country.

Although at first glance the Bank Statement appears rather formidable, its main features are simple enough. Each institution gives its capital; its net profits; the total of its loans, discounts and investments; the amounts of various kinds of money it has on hand; the amount of cash it has on deposit in other banking institutions which, under the law, may be counted as a part of its reserves; its own "net deposits"—that is, the total of the funds that have been placed in its care; and, in the case of a National Bank, its outstanding "circulation," or the total of the currency which it has itself issued.

The figures given out for each of the above items represent the average for all the days of the week covered by the statement. The average is used to prevent any temptation to "window-dressing," or trying to make an especially good showing for the particular day of the report.

The several items are then totaled in three groups—banks which are members of the Federal Reserve system; State Banks not members of Federal Reserve; and Trust Companies not members of Federal Reserve. Finally, the three groups are combined to give the total of each item for the entire Clearing House.

A supplementary statement is also issued showing the totals for each of the three groups on the day the statement is issued. This is called the "Actual Condition," and is in most general use for judging money conditions, since it gives the latest available information.

As the provisions of the new Federal Reserve law in regard to reserves are somewhat complicated, a special statement is added showing the "Reserve Position," both average and actual.

With such complete weekly statements of

the condition of each bank, manipulation of the accounts becomes impossible, and the statement of the New York Clearing House is perhaps the most important weekly financial showing in the world. Its only possible rival would be the statement of the Bank of England, and since that does not cover other London banking institutions it is necessarily less comprehensive. Certainly no other table of figures will show the trained observer so much about financial and economic conditions in the United States.

Surplus Reserves

The figures most closely watched by Wall Street are the Surplus Reserve and the relation between "Net Demand Deposits" and "Loans, Discounts, Investments, etc." The reserve consists of two parts—cash in vault, and reserve in the hand of other depositaries as permitted by the law—and this total reserve must equal or exceed a specified percentage of each bank's own deposits. If for any temporary reason a bank's reserve falls below this percentage of deposits, the reserve must be restored to the legal requirement at the earliest

possible moment, and State and Government officials will see that this is done.

When, on the other hand, the reserve exceeds the legal requirement, as it nearly always does, a "surplus" reserve arises, and the amount of this surplus shows the relative strength of the bank's cash position. Hence this item is carefully watched as an index to the supply of money available for loans. Since a great many securities are always being carried by their owners partly on money borrowed from the banks, the amount of this surplus reserve has a more or less direct relation to the stock market.

The relation between deposits and loans is not so generally understood as the surplus reserve. These show not so much the condition of the banks as the condition of the business men who are their patrons. When the banks' customers are depositing more money than they are borrowing, they are manifestly prospering. When they are borrowing more than they are depositing it is evident that they are not so prosperous, and when this condition continues for a long time a danger point may be reached where some business men have

difficulty in meeting their loans and may even have to fail.

Under normal conditions the total loans of Clearing House institutions may be somewhat greater than deposits, because a bank may lend not only the money that other people deposit in it but also its own money—that is, its capital and its surplus of net profits. Hence if deposits exceed loans, a strong position is shown; but when the loans begin to show a large excess over deposits the situation will bear watching.

It must be noted, however, that loans made on Government bonds or Treasury certificates as security are considerably different from loans made on ordinary business men's notes, arising out of general trade. These Government securities are so nearly equivalent to money that loans made on them have a much higher standing than loans on commercial paper. And when an excess of loans over deposits consists entirely or almost entirely of these loans on Government paper, it does not necessarily indicate any special weakness in the business situation.

The Clearing House

The "clearing" of numerous transactions between two or more persons by offsetting one debt against another and so simplifying the payments to be made, is a custom so old that its beginnings can hardly be traced. In Roman law it was called *compensatio*. The principle was used throughout the Middle Ages and it is rather surprising that the New York Bank Clearing House was not organized until 1853.

It is a slow process for each bank to collect checks from all the other banks separately, involving a great waste and duplication of time and labor. This is avoided by establishing—to quote from the Pennsylvania Supreme Court—"a place where all the representatives of the banks in a given city meet, and under the supervision of a competent committee or officer selected by the associated banks, settle their accounts with each other and make or receive payment for balances and so 'clear' the transactions for the day for which the settlement is made."

Every bank is, in essence, a merchant of credit, constantly buying credit from its de-

positors and selling credit to its borrowers; and credit which is vouched for by established banking institutions is practically a uniform commodity. Since Wall Street is a sort of central market for this credit, serving the whole country, there are a vast number of credit transactions which may be offset against each other without cash payments. New York City bank clearings for 1915 were $110,563,374,000, which was 59 per cent. of the total for the whole United States. Moreover, the ten largest New York banking institutions clear more checks than all the rest of the Clearing House combined, so that the handling of the country's credit is pretty well centralized.

Whether or not there are dangers arising from this extreme centralization, it is exceedingly convenient and efficient. Each institution sends two clerks to the Clearing House every day, one to present checks to other banks and one to receive checks from them. The process usually takes only a few minutes! Seven of the biggest institutions clear their mutual exchanges by themselves an hour earlier, in order to accelerate the final clearing.

Payments amount to about four per cent. of

the total clearings, as a rule. They are sometimes made in cash and sometimes in Clearing House certificates representing deposits of cash by member banks in the Clearing House vaults.

The Clearing House also serves the purpose of bringing all the banks together into a central organization for other objects besides the simple process of clearing checks. Banks which are entirely solvent, but have become involved in temporary difficulties, are often assisted by the Clearing House and thus saved from suspension; and, in times of panic, Clearing House loan certificates have several times been issued to take the place of money. In 1907 this practice spread all over the country, and was undoubtedly the means of preventing a general crash. In future the notes issued by the Federal Reserve banks will obviate the necessity of Clearing House loan certificates.

The Sub-Treasury

Of the nine Sub-Treasuries which act as branches of the Treasury Department at Washington in receiving money and paying

Government bills, the one in the Wall Street district handles about two-thirds of the total business.

The relations of the Sub-Treasury with the banks are necessarily close. The assistant treasurer, who has charge of it, is a member of the Clearing House, and in times of stress he is in frequent consultation with leading bankers and co-operates with them in handling the situation.

The Sub-Treasuries were established in 1846 because the Government had lost considerable money through the failure of depositary banks in which it had been kept. From then until the establishment of the National Bank system in 1864 the Government kept entirely free from the banks, and even after that most of the Government's balances were held at the various Sub-Treasuries.

In times of prosperity the Government receipts were naturally large and consequently the Sub-Treasury withdrew a great deal of money from the market just when it was most needed. In recent years, therefore, it became necessary for the Secretary of the Treasury to deposit Government money in the banks at

times to prevent stringency in the money market.

Now that the twelve Federal Reserve Banks are in operation, the Sub-Treasuries are beginning to look like an unnecessary duplication of Government facilities, since the banks could without difficulty perform all the work.

CHAPTER III

The Money and Credit Markets

THE word "money" is used in Wall Street and in commercial circles generally to mean two entirely separate and distinct things. This is unfortunate, since it causes a great deal of confusion in the minds not only of students and novices, but even in quarters where a better knowledge might naturally be expected. It is therefore necessary to get these two meanings thoroughly in mind before considering the workings of the money market.

The first meaning of money is cash or currency—gold, silver and paper money of all kinds. This is the money we carry in our pockets, or which is deposited in the Sub-Treasury, or imported and exported, or shipped back and forth between the country banks and those located in the big financial centers.

The second meaning of money is short-term credit, such as call loans, time loans, commercial paper, checks, bank deposits, etc. For example, when a man says he has money in his

purse he refers to the first meaning of the word, but when he speaks of his money in the bank he means something very different—his credit balance at the bank.

This double use of the word grew up because a credit balance at the bank could be instantly turned into money at any time. When the savings bank depositor takes a hundred dollars of cash around to his bank and deposits it, he knows that he can draw that cash out again whenever he wants it, and very naturally he speaks of his "money" in the bank; but the bank does not hold all its depositors' money in the form of cash. If it did it could not pay any interest, since to earn interest it must loan the money out in some way. The bank simply credits its patron with the amount of his deposit, and what he really has in the bank is a credit balance.

Thus the "money market" is really a credit market, for hardly any one ever borrows or lends the actual cash. Nearly all the transactions in the money market are in bank checks, which merely serve to transfer bank credits from one person to another. Even loans on the notes of business firms—commer-

cial paper—which may run for six months or a year or even longer, are included in the general term "money market."

How the Money Rate is Fixed

Since credit can be transferred anywhere in the United States by the simple process of mailing a check, or even by telegraph if necessary, the whole country is practically included in the "money market." A merchant in Kansas City wants to borrow $10,000 for the purpose of increasing his stock of goods. He goes to his bank and if his credit standing is good the bank lends him the money. This perhaps leads the Kansas City bank to withdraw $10,000 which it was carrying on deposit in a Chicago bank, and may again lead the Chicago bank to draw an equal amount from its New York correspondent bank or trust company.

In all these transfers of credit no cash is moved unless the bankers of one city or community, taken as a whole, begin to find themselves short of cash. Then they arrange for the transfer of currency or gold from some other city.

For instance, if Chicago banks find them-

selves running short of cash while New York still has plenty, the rate of exchange at New York on Chicago will rise to such a premium that it will be cheaper for New York to send the actual cash than to buy exchange on Chicago. The workings of the foreign and domestic exchange markets will be explained more fully in the next chapter.

Most of the borrowing and lending done in the entire country is thus arranged privately between individuals or firms and institutions and the rates of interest are fixed by two influences: (1) the credit standing of the borrower—the rate being lowest to the concern whose credit is the strongest; and (2) the general demand and supply of money, as observed by each bank in its dealings with business men and with other banks.

Under ordinary circumstances more than half of the total bank clearings of New York City result from stock and bond operations of one kind or another, though not all on the Stock Exchange.

Call Money

The principal form of credit that arises from these extensive security transactions is that known as "call money." The broker or dealer in stocks and bonds naturally wants to borrow the very large amount of credit that he requires at the lowest possible rate of interest, and the bank can afford to allow the lowest interest rate on loans that it can call in at any time when the money may be needed for other uses. This situation gives rise to the very general use of call money in Wall Street.

The market for call money is so broad and so large a part of the demand is from members of the Stock Exchange that it is convenient for the brokers to gather in the "money crowd" after the close of the regular market each day and bid for and offer call money just as they do a stock during the session. The principal supply comes from a comparatively small number of institutions that make a sort of specialty of this class of business.

While the interest rate on call money is generally lower than that on money loaned for a fixed period of time, it may be higher under exceptional circumstances. When there is a

great scarcity of available credit, usually as the result of panic, time loans may be unobtainable, and since the broker must have credit or fail, a tremendous demand sometimes converges on the call money crowd, forcing the rate to high figures. There have been occasions when the rate has gone to 365 per cent. or even higher—call money being excepted from the operation of the usury laws.

It is probable that these extreme quotations for money have now been done away with by the new Federal Reserve Bank system, since that provides for an elasticity of currency and credit in cases of emergency that will prevent the conditions that have sometimes arisen in the past when money was almost unobtainable at any price.

Commercial Paper Rates

The call money rate fluctuates so widely and at times so violently that it does not afford the best index of the money market as a whole. The commercial paper rate, however, reflects general money conditions pretty faithfully and is the nearest approach we have to the official Government bank rates of Europe.

Six per cent. has in the past been a relatively high rate for commercial paper at New York and 4 per cent. has been a relatively low rate. After the Federal Banks went into operation, in November, 1914, money rates tended downward and for two years were abnormally low. This was partly due to the great increase in credit made possible by the new law and partly to the big gold imports resulting from the war demand for our products abroad.

This was a temporary condition and in due time commercial paper rates again reached 6 per cent.; but it is likely that such extreme rates as 8 or 10 per cent. at New York will in future be avoided, for the same reasons that will prevent very high call money.

Credit in the Banks

Since the banker is primarily a merchant in credit, any considerable increase in borrowing either on collateral security or on commercial notes will at once be reflected in the loan accounts of the banks. And a moment's thought shows that it will also be reflected in the deposit accounts; for when the banker grants a

loan to his customer he simply credits the amount of the loan to the customer's deposit account with the bank. Thus bank loans and deposits tend to rise and fall together.

Since the bank has the right to loan out not only the money deposited with it by its patrons but also its own capital and surplus if it so desires, loans may exceed deposits and, taking the country as a whole, they nearly always do; but for the New York banks (excluding the trust companies) loans and deposits are usually not far from equal, sometimes one account being the greater and sometimes the other.

Credit Based on Money

Since the banks have to keep a fixed per cent. of cash reserve behind their deposits, and since deposits rise with an increase in loans, it follows that cash reserves set a limit on loans. This condition has often been likened to an inverted pyramid, the cash forming a small base at the bottom on which a large amount of credit is built up. A comparatively small increase in cash permits a large growth of credit,

while a decrease in cash necessitates a much greater contraction of credit.

Changes in the supply of cash in the banks depend upon four factors:

(1) The amount of money—in the sense of cash and currency—being used by the business of the country; that is, carried about in people's pockets, kept in their tills, or hidden away in old stocking-feet. There is more difference in this factor at various times than might be expected at first thought. When people are prosperous they carry more money. When business is good, tradesmen have more money in their cash registers. And when for any reason a feeling of panic spreads among the people, a great deal of money is hidden away.

The reason is that panic at times jerks the cash out from under the pyramid of credit and brings the structure down with a smash. In the past we have had no way of increasing the supply of cash at such times, but the Federal Reserve law permits such an increase and it is hoped that panics may thus be avoided.

(2) Exports and imports of gold.

(3) Production of gold in the United States.

(4) The amount of cash carried in the several Sub-Treasuries. DEF. PAGE 30

Since Wall Street is the great banking center, any increased demand for cash is usually passed along to Wall Street by the country banks. On the other hand, gold imports and Sub-Treasury operations are mostly centered at New York, so that any increase in the supply of cash is quickly felt there. The result is that Wall Street, in this matter of cash supply as in most other ways, is a sort of barometer of conditions, and is far more sensitive to changes than other sections of the country.

Brokers' Credits

Active brokers often buy and sell several hundred thousand dollars worth of stocks or bonds in a single day. These are paid for by certified checks. Hence the same broker may pay out half a million dollars in certified checks during the day, while at the same time he receives an equal amount from other brokers. If there were no way of off-setting these credits before the end of the day, he would have to carry half a million dollars of loans all the time simply as a matter of bookkeeping.

To avoid this the practice of over-certification arose, by which the bank certified the broker's checks to an amount exceeding his credit balance with the bank at the moment, while the broker restored his balance before the end of the day by depositing other checks.

This practice has been held to be illegal and has now been mostly abandoned in favor of other methods. One method is for the broker, when doing a heavy business, to make frequent deposits during the day, so that his account at any hour, if it were to be reckoned up, would show a credit balance. Another method is for the bank to make a "morning loan" to the broker on his note, thus substituting his personal credit for over-certification.

CHAPTER IV

Foreign and Domestic Exchange —Balance of Trade

THE subject of foreign exchange is usually considered so complicated that the average man makes no effort to understand it except in the most hazy and general way. Yet the principles on which it is based are simple and even the details of exchange operations are not so difficult as they are commonly esteemed.

Suppose, for example, that A, an American dealer in cotton, makes a sale to the value of £10,000 to a Liverpool firm, B. Of course, B does not want to go to the expense and trouble of sending £10,000 in gold to America, so he cables A to draw on C, a London banker with whom B has a deposit, for the amount due. A then makes a draft, or bill of exchange, on C for the £10,000 and deposits it in his New York bank, where he is credited with the value of the draft in dollars at the current rate of exchange.

The draft is usually accompanied by the bill of lading and insurance receipt for the shipment of cotton, and it may be payable on demand or in 30, 60 or 90 days, according to A's arrangement with B. Interest on the money up to the date when it can be actually obtained in London is deducted from the credit allowed A by the New York bank.

Since there is always a large general trade in all sorts of merchandise between England and America, a great quantity of these bills of exchange are always afloat in New York. They are transferred by indorsement just like checks, and of course, the more indorsements they bear the stronger they become. Hence a market arises for them and they are sold back and forth like stocks or wheat. When the demand exceeds the supply the price of exchange rises above par—which is $4.8666 for the amount of gold contained in the pound sterling—and if the supply exceeds the demand the price falls. Thus we have a daily market price for sterling exchange and in the same way for exchange with all other commercial countries.

The upper limit of the exchange rate is the

cost of shipping gold to make the necessary payment, and the lower limit is the cost of importing the gold; for the American banker who must make a certain payment at London would be foolish indeed to pay more for a bill of exchange than it would cost him to send the gold—gold being the only form of money that is generally acceptable in making international payments. The gold export and import points vary with the cost of freight and insurance on the gold. Under normal conditions the export point is about $4.884 and the import point $4.833.

Thus the main factor in fixing exchange rates is the relation between the amount of money we owe other countries and the amount they owe us.

Influence of the Money Rate

There is, however, another factor which often has considerable influence, and that is the relative interest rates on money in the two countries involved. Every bill of exchange represents money and money may be worth a higher rate of interest in New York than in London. In that case the London banker to

whom a payment is due will naturally prefer to leave the money in New York and have it loaned out at interest there. Hence New York does not have to make the payment at London at that time, this decreases the demand for New York exchange on London, and therefore the sterling rate at New York falls. Likewise if interest rates are higher in London, New York bankers want to send money there to be loaned, which increases the demand for sterling exchange and raises the rate at New York.

Eventually, however, whatever is owed has to be paid, so that the influence of money rates is only temporary.

Domestic Exchange

The principles of foreign exchange apply in exactly the same way to domestic exchange between the various cities of one country. In England this is known as "inland exchange."

At New York, for example, exchange rates are regularly quoted on Boston, Chicago, St. Louis, San Francisco, etc., and these rates go to a premium or a discount according to whether the balance of payments between two

cities is in favor of one or the other. In this case shipments of money can be made in currency and not necessarily in gold, but the money will not move from one city to another unless it is cheaper to send it than to buy a draft at the current rate of exchange.

How International Payments Arise

When we begin to go deeper into the subject and discuss the various reasons which lead people to want to make payments in other countries, and therefore affect the rates of exchange, we naturally find many complications, for these reasons cover pretty much the whole field of financial, economic and business conditions.

Broadly speaking, international payments arise from:

(1) The purchase and sale of merchandise, including all raw and manufactured products.

(2) Securities bought and sold.

(3) Interest payable on foreign investments.

(4) Money loaned abroad and its repayment.

(5) Expenses of travellers.

(6) Freights and insurance payable to the

country where the shipping or insurance companies are located.

(7) Remittances by immigrants, whether gifts to individuals or deposits in foreign banks.

With the exception of the first, the amounts of these several items can be only roughly guessed at. Our Government keeps a record of merchandise exports and imports, although it is to be feared that it is not as accurate as might be desired. Imports, in particular, are often undervalued in order to reduce the amount of *ad valorem* duties to be paid. The totals of exports and imports, of merchandise and gold separately, are given to the press monthly.

In regard to the other items only indefinite estimates are possible.

Finance Bills

Item (4), money loaned abroad, is especially important, since it may radically affect the rate of exchange, especially between New York and London. Temporary loans between the bankers of the two cities are effected by means of "finance bills," as they are called, which are

in essence nothing but 30, 60 or 90 day notes, issued in the form of bills of exchange drawn on foreign banks. During periods of very high money rates at New York, the bankers of that city have often sold these finance bills to London in large amounts, lending the money thus obtained at rates returning a satisfactory profit.

The operation represents merely a transfer of credit. London banks are glad to get the finance bills, as they can thus get a higher rate of interest than could otherwise be obtained with the same degree of security, and the New York banks in turn are able to make a profit by reloaning the money at a still better rate.

In times of panic the extensive issue of finance bills has several times affected the exchange rate so much that many millions of gold have been transferred from London to New York as a result.

An International Clearing House

It will be seen that the foreign exchange market as a whole serves as a sort of international clearing house, by which all the international business transactions of the world are offset against one another so far as it is possi-

ble for that to be done, so that the actual transfers of gold needed to balance the account are few and far between in comparison with the tremendous aggregate of the business handled.

Foreign and domestic exchange do for business substantially what the bank clearing house does for bank checks.

Exchange operations frequently become very complicated. For example, suppose an American manufacturer has sold $10,000 worth of agricultural machinery to Russia, a Russian grain dealer has sold $10,000 of wheat to Germany, a German exporter has sold a like value of toys to South America, and Brazil has sold the same amount of coffee to London, while London has loaned $10,000 to New York on finance bills. Evidently these transactions, taken together, will balance each other without any transfer of gold; but before that can be accomplished it is necessary for the bankers of the five different countries to get in touch with each other in some way.

London, by the prolonged leadership of England in foreign commerce, has grown to be the center through which such roundabout

transfers of foreign exchange are handled. It had always been, up to the beginning of the European war, the foreign exchange clearing house of the world, and it is likely that it will resume that position now that the war is over.

Balance of Trade

The term balance of trade is applied to the excess of a country's merchandise exports over its imports, or the excess of imports over exports. For a long time it was generally believed that, for a country to be truly prosperous, it must export more merchandise than it imported, thus getting a money balance in its favor.

The absurdity of the idea is evident when we consider the prosperity of the world as a whole. It would be manifestly impossible for all nations to go on continuously importing gold on balance, hence, according to this theory, one country could prosper only at the expense of some other country. Economists have long since come to see that foreign trade is mutually beneficial to all the nations involved. If England is short of wheat and America is short of tin, it is plainly to the

advantage of both to exchange wheat for tin.

Moreover, as we have already seen, our foreign trade in merchandise is only one of numerous factors which affect the exchange market and eventually lead to the export or import of gold. Under normal conditions before the war the United States had a big yearly excess of merchandise exports over imports, and this excess went to pay the interest on our securities owned abroad, expenses of our foreign tourists, transportation charges owed to foreign steamship companies, etc. The situation is now reversed, in that Europe owes us a big annual balance of interest payments instead of our owing Europe. How Europe will meet these payments is as yet unsettled.

But although our exports or imports balance has no permanent significance, it does have an important bearing on our immediate prospects for prosperity or depression in business. An unusually large export balance of merchandise means an early flow of gold and credit to this country, and that must necessarily exercise a powerful and beneficial effect upon our industries and our security markets. On the other hand, if our exports balance falls to a low level or is even transformed into an

import balance—as occasionally happens—gold or credit or both will flow out of our banks to foreign countries, to our temporary disadvantage.

For this reason Wall Street always watches the gold movement closely and studies the monthly figures of our merchandise balance of exports or imports.

An unusually heavy movement of merchandise exports may not result in immediate gold imports, for our bankers may prefer credit to gold. If our bank reserves are overflowing with gold, there is no advantage in drawing more gold from abroad simply because it is due us on the balance of our merchandise exports over imports. If London owes New York $100,000,000 as a result of our big exports, New York may prefer to leave the money at interest in London, and, of course, will do so if the interest rate is higher abroad than at home.

Considered as a broad economic question, there is neither advantage nor disadvantage in a "favorable balance of trade." But the immediate effect of such a balance on our business conditions is always stimulating.

CHAPTER V

The Corporation as an Element in Wall Street

SINCE all stocks and bonds are issued by corporations, there would be very little to Wall Street without the corporation. It is the corporation which makes possible the centralization of capital, the accumulation of great funds in a single organization and the unified control of big enterprises. Hence without the corporation the stock and bond markets would be non-existent, the money market would be much more restricted and even the foreign exchange market would be somewhat affected.

About the only department of the Street which would be uninfluenced by the abolition of corporations would be the commodity markets. At present a great deal of business is done even in cotton, grain, coffee, copper, etc., by corporations, but the corporation is not a necessary element in the handling of those lines.

Origin of the Corporation

The idea of creating "an invisible, intangible person existing only in contemplation of law," endowed by the state with the right to transact certain business and limited by a charter, originated in Rome, as did most of the devices of modern commerce.

Under the Roman law three or more persons might organize a corporation. Apparently each person must have had something to show for his part in the ownership, corresponding roughly to the stock certificate of our times, but exactly what it was history has not recorded. From the fact that the Roman law had so little to say about corporations it is natural to conclude that such organizations did not enter largely into the business life of that day.

The business corporation as we now know it is of very modern growth. In deciding a case in England in 1770, Lord Mansfield said of the stock certificate: "This is a new species of property arisen within the compass of a few years." The point to be decided in that case was whether a stock certificate was money

and Mansfield held that it was not. The very nature of the suit shows that at that date stock certificates lacked definite standing in the courts.

Hence the corporation as an important element in business made its appearance almost simultaneously with the birth of the United States as a nation, and it is here that corporations have made the greatest growth and have been subjected to the least legal control. This has been due largely to the division of powers between the states and the Federal Government. As each state has the right to charter corporations, the states have competed with one another for the business and have therefore been more and more liberal in the powers granted by charter. Of late, however, it has appeared that the corner had been turned in this growth of liberality on the part of the several states, and the Federal government, through its control of interstate business, has been taking an increasing hand in corporation control.

The Corporation a Necessity

While there is now, and always has been in this country, a good deal of antagonism toward the corporation because of frequent abuses of power, yet the great majority of the people recognize the absolute necessity of some such form of business organization.

It is difficult to imagine any way in which the Pennsylvania Railroad, for example, could be managed except as a corporation. To build up such an enterprise a vast amount of capital must be drawn together and welded into a practical, working unit. Each contributor must have something to show for his part in the enterprise. The business must be controlled by officers, for the number of partners is too great for personal consultation in regard to the policies of the company. The powers of these officers, as well as the rights of the partners, must be established by law, as otherwise the officers would be too nearly omnipotent for the good of either the community or the stockholders.

Also, the business of such a company is of necessity permanent. The death of a partner

cannot be permitted to disturb the continuity of the enterprise. Business policies must be laid out far into the future, with a view to the successful development of the company and without regard to the immediate financial necessities of any individual. In the building of the Pennsylvania tunnel and terminal in New York City the officers of the company were looking ahead half a century or more, and that far-sighted, impersonal view is absolutely necessary for the best results, no matter whether we consider the interests of the stockholders or of the public.

The Holding Company

Among the powers frequently granted by the states to corporations has been that of buying and holding the stocks or bonds of other corporations. Out of this arose the holding company—a corporation formed for the purpose of owning and controlling other companies. Around this plan a tremendous amount of litigation has centered, but the holding company still exists and is practically undamaged in its essential features.

The holding company is not strictly neces-

sary for the transaction of business, as is the corporation. We could get along very comfortably without it. But it has substantial advantages when its great powers are not abused. The principal advantage has undoubtedly been the greater facility with which a big business unit can be built up.

Perhaps there is a point beyond which the growth of the business unit brings no additional advantage, though that remains to be proved. The fact that some widely extended corporations have shown a tendency to fall to pieces of their own weight does not necessarily show that they were too big—the trouble may have been that their managers were not big enough. But the fact has certainly been demonstrated that as a general rule the big business has advantages over the little business in permanency, in economical operation, in distribution of risks, and in obtaining and being able to pay for competent managers.

The holding company is especially useful in handling doubtful or highly speculative undertakings. For example, take a dozen small companies each of which is engaged in developing a prospect for a gold mine. Each of these

dozen different enterprises is necessarily doubtful, for the prospect may not prove to be a good one. Even after the mine is in operation the supply of paying ore may give out at any time. Hence investors hesitate to put their money into it. But when the twelve small companies are combined under the ownership of a holding company the risks are greatly reduced. If one mine proves a failure another may do twice as well as expected. If a vein "pinches out" at one point a still better vein may be located elsewhere. The stockholders in the holding company get the benefit of the principle of averages and their investment is therefore much more secure than if placed in any one mine alone.

The same principle applies to the public utility holding company, which operates, perhaps, street railways, gas and electric companies in twenty different cities. If the gas business is less prosperous than expected, the electric branch of the undertaking may be more so. If one city fails to flourish, another may grow with unexpected rapidity. The investor is safeguarded against accident and his average yearly returns are more secure.

There are two principal objections to the holding company. One is that minority stockholders in subsidiary companies may not get a fair deal, because the interests of the holding company as a whole may not exactly coincide with the interests of minority stockholders in the various sub-companies. The other is that the multiplication of corporations like wheels within wheels makes dishonest management easier to conceal.

Whatever tends toward simplicity of organization is best and likely to prove most permanent. For that reason a direct merger of several small corporations into one larger one, where that is possible, is undoubtedly better than to employ the holding company device. This is the direction in which corporation organization is now tending, but such a merger is often difficult to bring about, and the device of the holding company may sometimes permit a beneficial enlargement of the unit of business operation which otherwise could not be obtained. In many cases the holding company comes first, as the only possible way at the time to get the benefits of larger operations,

and is followed later by an outright merger when that becomes feasible.

Stock Watering

When a corporation is formed the question at once arises how much stock shall be issued. Since each share of stock represents nothing except a fraction of the whole enterprise, it really makes no difference how many are issued. If the business is worth $1,000,000 and only 1,000 shares are issued, then each share is worth $1,000; if 10,000 shares are issued, each is worth $100; and if 100,000 shares are issued, each is worth only $10.

The trouble arises when each share is given a par value—a term which as applied to stocks really means nothing at all. If in the above case 100,000 shares were issued having a nominal par value of $100 each, then, according to the current use of the terms, nine-tenths of the stock would be "water"—that is, would represent no tangible value. But the real mistake is in giving the shares a par value of $100 when they represent only $10 each, and if the investor understands—as most investors do if

they stop to think—that the term par value does not pretend to represent the actual value of the property behind the stock, then he is not deceived, and the question of how many shares of stock are issued is merely one of bookkeeping.

In practice it is generally impossible to say just what value any share of stock represents, because the worth of the whole enterprise does not necessarily depend on the value of its tangible assets. A corporation owning $1,000,000 worth of property may not be able to earn anything for its stock, while another owning only $100,000 worth may pay 50 per cent. yearly on its stock.

For the above reason it is gradually becoming the custom to assign no par value to an issue of common stock. Each share then purports to be just what it is—a specified fraction of an enterprise, of unknown value. It is the business of the investor to decide for himself what that value is.

It is curious how often the public gets excited about the wrong thing. Probably the majority of the people consider "watered stock" the crowning iniquity of Wall Street;

yet the whole trouble lies in the highly respected term "par value." A bond or a note has par value, because it represents a specified amount of money to be paid at a definite time. A share of stock has no par value because it represents nothing but a fractional ownership in the company, which may be worth at some times more, at other times less.

Preferred Stock

Since a stock certificate represents nothing but a share in the business, why do we have two classes, preferred and common? The answer is, to accommodate different kinds of investors. Investors wish to take differing degrees of risk for corresponding degrees of profit. One wants merely his interest and his original money back in two, ten or fifty years; he buys a bond. Another is willing to take a direct share in the business, but wants to be reasonably sure of his interest; for him the preferred stock is created, giving him a higher interest than the bond but limiting the interest rate to a fixed amount yearly, so that he is excluded from the higher rate of profits that the common stock may some time earn; a third

is willing to take the greater risk of the common stock in the hope of participating in the greater profits which may accrue to it.

It is a somewhat common practice for a corporation to issue preferred stock up to the estimated value of its tangible property (after deducting the amount of the bonds outstanding), thus leaving the common stock to represent only good-will, patent rights, and probable or possible earnings above ordinary interest rates. Then if the business turns out as well as expected the common stock gradually becomes more and more valuable; but if results are disappointing the common may never have any real value.

There need be no serious objection to this method of organization so long as the buyer of the common stock knows what he is getting, but there is a phase of dishonesty in engraving "Par Value $100" on stock certificates of this character. At best it can only mean that the promoters hope the stock will some day be worth $100 a share. And yet Congress is considering a law to prohibit the issue of stocks without a par value!

Limited Liability

A partner in a business is personally liable for all its debts. A small partner—say the owner of one share—in the Pennsylvania Railroad could hardly take this risk. Hence it is necessary that the liability of stockholders be limited to the amount paid in. The worst that can happen to them is to lose their investment.

On the other hand, this evidently increases the danger of foreclosure and reorganization during periods of unprofitable business. The members of a partnership may pull through by using their personal credit, but the corporation has no personal credit.

Foreclosure may be forced by any holder of the company's bonds, notes, or unpaid accounts due, who cannot get his money from the company. Under foreclosure the common stockholders can usually regain control of the company if they are willing to put up the necessary money to pay its debts and set it on its feet again—which, of course, they hardly ever do. Sometimes the preferred stockholders reorganize the business and pay its debts; but in most cases the company goes to the bondholders, who are obliged to take it over and run it in order to get their money out of it.

CHAPTER VI

The Bond Market

WHEN a corporation desires to attract capital, for the prosecution of an enterprise that its managers believe will prove profitable, it will naturally offer for sale different classes of securities adapted to the varied requirements of the numerous investors who are to be interested.

For the man who wants to be an actual partner in the enterprise, to take the risk of its failure along with the possibility of very large profits, the common stock is created. For the more conservative investor, but who nevertheless wants a good interest return, one or more classes of preferred stock are issued.

But a large number of investors do not want any share in the enterprises at all—they simply want interest on their money. For them bonds are offered, bearing a fixed rate of interest and payable in cash at maturity.

What Is a Bond?

The bond itself is nothing but a note under seal. In that particular all bonds are alike.

But the essential feature of a bond is the security behind it, and in that bonds vary in almost every conceivable way.

There may in fact be no security behind the bond. It may be nothing but the corporation's promise to pay—an unsecured note—as in the case of the debenture bond. Such a bond is a lien on the assets of the company, but not on any specified assets. Hence all creditors who have any specified liens on particular assets must be satisfied before the holders of the debenture bonds can get anything.

Almost any sort of provision can be inserted in a bond. For example, there is the income bond, on which interest is payable if it is earned and not otherwise. The only way in which it differs from the first preferred stock is that it has a definite date of maturity while the stock has no maturity. It is a very poor class of security. The object in creating an income bond is to attach a high sounding name to a low grade of security.

The great majority of bonds, however, are secured by mortgage. Such a bond is practically a fraction of a mortgage; that is, each bond is a note under seal, and its security con-

sists of a fraction of a mortgage which covers all the bonds of that class together.

The property covered by the mortgage is explained in the bond, and is of course specified more exactly in the mortgage itself. It may be a first, second or third mortgage, in which case the first must be satisfied before the second, the second before the third, etc.

It may be a "general" mortgage, covering a great deal of property on which other mortgages have already been placed—the other mortgages constituting "prior liens." In such cases a long investigation is usually necessary to find out exactly what security lies behind the general mortgage. The individual investor is hardly ever in a position to make such an investigation and he has to depend on his bond dealer to make it for him. For this reason he should deal only with bond houses of established reputation.

The name of a bond tells nothing about its degree of safety. For example, a debenture bond, which is an unsecured note, may be a great deal better than a mortgage bond. It depends on what other securities precede the bond in each case and on the amount of assets

and earnings available for that particular bond. A municipal bond is practically a debenture, but since it is not preceded by any other form of security it constitutes a lien on the property within the municipality and therefore as a rule ranks very high. Some industrial corporations have no bonds outstanding except a small amount of debentures, and their bonds therefore may rank much higher than the general mortgage bonds of a railroad which is liberally plastered with prior liens.

Some very odd situations are encountered in the study of bonds. There is a small railroad in the South which has no securities outstanding except first mortgage bonds and short term notes for floating indebtedness. In this case the bonds are about equivalent to stock; for the notes mature first and being all construction liens of one kind or another they get the first crack at the assets. The bondholders are the sole owners of the property, but nevertheless they are entitled only to their interest and payment at maturity. If a big surplus should be built up it would belong to the company, but no individual could get any of it without a change in the form of the organization.

The convertible bond should perhaps be classed as the highest form of security which can be issued—provided, of course, that it is well secured by having plenty of assets behind it. A convertible bond is one which may be turned into some other form of security—usually stock—under conditions specified therein. For example, take a debenture bond having abundant assets behind it and convertible into common stock at par at the option of the holder—a common form of convertibility. So long as the company's earnings on its stock are small, the owner of the bond draws his regular interest as a bondholder; but if earnings become large, so that the stock sells above par, he can convert his bond into stock and thus participate in the profits on the stock.

A fact not usually mentioned is that the existence of convertible bonds operates against the interests of the stockholders, for the amount of stock outstanding is automatically increased when the earnings become large enough to carry the stock above the conversion price. The possibilities of profit on the stock are cut down by an amount equal to the participation of the bonds.

It is evident, then, that the investor cannot allow himself to be influenced in the least by the name of any security that may be offered to him. There is no magic in the word "bond." It is necessary to go further and find what security lies behind the bond and what prior liens precede the bond in their claim on the assets or on the specified property on which the bond is based.

The Market for Bonds

Nearly all railroad bonds are listed on the Stock Exchange and traded in on the floor. Many other bonds of which large amounts are outstanding, so that buying and selling of them is frequent, are also listed.

Only a small part of the total trade in bonds, however, is transacted on the Exchange, because of the immense multiplication of the number of issues. Most of the dealings in bonds proceed "over the counter" and the proportion of the bond trade on the Stock Exchange to that outside is growing steadily smaller.

The "bond house" occupies a very important position in the Street. When an issue of bonds is contemplated the issuing corporation usually

seeks the assistance of one or more of the leading bond houses in placing the bonds among investors. This is necessary because the private investor has not the facilities for investigating the assets behind the bond or determining its value. It is the business of the bond house to make the investigation and if the conditions under which the bond is issued are found to be satisfactory it is then offered to the customers of the house at what is considered to be a fair price.

For this service the bond house makes a profit which on the average is considerably less than it would cost the investor to investigate for himself to say nothing of the fact that the investigation is likely to be much more thorough and dependable. The standing of the house is at stake with every bond it offers to its customers; therefore self-interest requires every effort to avoid mistakes.

Many bond houses acquire such a reputation for care and conservatism that their endorsement of a bond guarantees the success of the issue. Investors know that the house would not touch the bond if it was not "all right." In that way the well managed bond house

gets a following which gives it great power in the Street.

Some banking houses take the most extravagant precautions before endorsing a security. One such house recently called in an expert and asked him to look up a certain bond. He told the manager that the bond had already been investigated by a well-known authority and the report was available, and that he doubted whether he could add anything to it. The manager, however, replied that he already had that report but wanted the expert to make an independent investigation and confirm it or otherwise as the facts might warrant.

The result was that the expert went to the property in question and studied it as though he had never heard of it before. His bill amounted to nearly $2,000 and yet he was unable to add anything of importance to the facts previously in hand. But the banking house was perfectly satisfied.

With Accrued Interest

Bonds are commonly quoted at a certain price "and accrued interest." For example, a bond quoted at par would really be worth 103

the day before a three per cent. coupon was payable. If the coupon was semi-annual, the bond would be worth about 101½ three months before the date of payment, and so on.

The prices of many bonds change but little. Hence if they were dealt in "flat," or without regard to accrued interest, the price would gradually crawl up from one interest payment to the next, when the interest would be paid and the price would go back and take a fresh start. A price quoted on a bond at any time would result in loss of the interest if the buyer took up the offer a month later.

This caused so many complications that the custom was adopted of quoting bonds at a certain price "and accrued interest." A six per cent. bond quoted at par and interest three months after the date the last coupon was due would, for example, cost the buyer about 101½.

Bond Yields.

Another complication in fixing the value of a bond lies in the fact that it is to be paid off at par when it matures although it may in the meantime sell considerably above or below par.

The method usually adopted assumes that the investor will reinvest his interest at the same rate as the yield on the bond and elaborate tables are compiled which show the investor just what his actual yield will be on a bond at any rate of interest and due in any number of years.*

This method, is however, open to some objections. It assumes that an investor holding two bonds yielding respectively 6 per cent. and 4 per cent. will reinvest the interest from the first at an average rate of 6 per cent. and the interest from the second at 4 per cent. This he may not be able to do.

A fairer method would be to figure the interest rate on the reinvested sums at an average normal interest rate for the entire period; but what is such an average interest rate and how could it be determined? It is evident that there is no such thing as a general average interest rate. Interest varies according to conditions—with the money market and with the character of the investment. We could

* THE MAGAZINE OF WALL STREET also publishes a book "Bond Yields at a Glance," consisting of seven simple diagrams which show the yield to maturity of any bond. This plan reduces the bond tables to a much smaller and more convenient form.

not even find an average interest rate for past years, to say nothing of estimating it for the next 20 years.

It is probable, therefore, that the customary method is as good as any that would be practicable. It assumes that an investor holding a bond yielding 6 per cent. will be likely to seek a similar investment for his interest payments as they become available, and that the holder of a bond yielding 4 per cent. will follow the same principle.

CHAPTER VII

How Business Is Done on the Stock Exchange

THE wide public interest in the Stock Exchange really began with the twentieth century. The business boom which began in 1898 resulted in big advances in the quotations for all kinds of securities, and the rapid growth of the daily press and of the reading public brought this condition to the attention of millions of persons.

There is, of course, no way of knowing how many persons are actively interested in the market at any time. The number varies greatly, according to whether or not conditions are such as to encourage speculation. Certainly not less than 100,000 persons are actively interested in the sense of being frequent buyers and sellers, and it is very probable that the number is much greater.

Listing

Before any security can be traded in on the Stock Exchange it must be "listed,"—that is,

admitted to the list of securities dealt in. Listing does not imply anything as to the value or lack of value of the security. It simply means that the corporation issuing the security is legally organized, makes reports of its income and expenditures at least as often as once a year and issues a balance-sheet showing its condition at the end of its yearly fiscal period. The public must judge for itself what if anything the security is worth. The Stock Exchange confines itself to furnishing facilities for buying and selling the security.

The Exchange does not, and in the nature of the case could not, guarantee the correctness of all these corporation reports. As to that also the public must form its own judgment.

Objects of the Exchange

The constitution of the Stock Exchange says that "Its objects shall be to furnish exchange rooms and other facilities for the convenient transaction of their business by its members as brokers; to maintain high standards of commercial honor and integrity among its members; and to promote and inculcate

just and equitable principles of trade and business."

In regard to the first of these objects there is, of course, no difficulty. The second has been fairly well carried out—better, probably, than in any other line of organized business—but there have been occasional lapses. Without doubt the Exchange's present standards of "commercial honor and integrity" are higher than ever before. In fact, one's memory needs to run back only a decade to note a decided improvement in that respect. Just what the Exchange does toward accomplishing the third object it would be difficult to say, except as the third is included in the second.

Many believe that the Exchange should do more than it now does toward checking riotous speculation and that its listing requirements should be more stringent; but the authorities have always taken the position that the Stock Exchange should be the servant of the public, not its tutor—that its business is to furnish the people facilities for buying and selling legitimate securities, not to reform the morals of corporations or to guard the public against its own follies.

Exchange Members

There are 1,100 members of the Stock Exchange. These comprise the following classes:

(1) Capitalists, whose principal reason for holding memberships is the saving of commissions on their large purchases and sales. The annual cost of holding a membership is over $3,000 a year, including interest and dues. This represents the commission on more than 25,000 shares of stocks bought or sold, hence it is only large operators who can make any saving in this way.

(2) Brokers, who solicit business from the public and hold memberships to enable them to transact it.

(3) Room Traders, who buy and sell only for their own account. Most of them make their profits out of the small fluctuations, standing ready to buy a little below the current market or to sell a little above. On the Chicago Board of Trade they are called "scalpers" and the nickname fairly well expresses the nature of their business.

(4) Specialists, who make a specialty of dealing in one or more securities. Their gen-

eral method of business is similar to that of the room traders. This is the department of the business in which there is greatest opportunity for dishonesty. Active brokers leave with the specialist their orders to buy and sell the particular stock in which he is working, and he also buys and sells for his own account. It is obvious that it would be possible for him to "cheat" in the handling of these orders.

As a matter of fact, however, the Stock Exchange specialist soon finds that honorable dealing pays him best—not to credit him with any higher motive, which, of course, often exists. The specialists are a necessary part of the machinery of the Street and generally speaking they handle their part of the business fairly, though not always to the complete satisfaction of brokers and their customers.

(5) Two-Dollar Brokers, who execute orders for other brokers at the established rate of $2.00 a hundred shares. There are two or three hundred of these, and they are always ready to handle business for brokerage houses dealing direct with the public in case the regular representative of the house has not the time to take care of all his orders.

(6) Odd Lot Dealers, who stand ready to buy or sell lots of less than 100 shares. Their business is about like that of the room traders, except that they do not deal in 100 share lots except for the purpose of evening up their purchases and sales in odd lots.

These dealers have a standing agreement as to the terms on which they will buy or sell odd lots. The market for any stock never consists of a single quotation, but of a bid price and an asked price. This is equally true whether the trade to be executed is for 100 shares or for an odd lot. An order for 100 shares coming through a brokerage house can be bought at the offered price or sold at the bid price. These prices are usually $\frac{1}{8}$ or $\frac{1}{4}$ apart.

The odd lot dealer, therefore, buys or sells on the same terms—he will buy at the bid price or sell at the asked price. The only important way in which he differs from many other room traders is that he deals only in odd lots.

The odd lot dealer, however, does one thing that the other room traders do not do—he will buy $\frac{1}{8}$ below or sell $\frac{1}{8}$ above the *next quota-*

tion after the order reaches him. Thus it often happens, in an inactive security, that the odd lot customers may actually get a better execution than if his order had been for 100 shares.

In this matter a good deal of confusion arises from the fact that the execution of a 100 share order is quoted on the tape, while the odd lot trade is not quoted. The 100 share order is certain to be executed at the apparent market because it creates the market, but the odd lot execution may appear to be a fraction away from the market, even though a 100 share order executed at the same moment would have been at exactly the same price as the odd lot execution. For this reason the odd lot customer usually believes that he gets an execution about ⅛ "against him." Taking the average of all odd lot orders and all 100 share orders for any day, it is a question whether any difference worth mentioning could be discovered in favor of the 100 share trader. If so, the average difference would certainly not be more than 1-16.

"Seats" on the Exchange vary in market value according to the amount of business

being done. The term is now out of date, as members have no regular seats, nor, as a rule, time to sit in them if they had them. The word "membership" is often used instead. In 1871 seats sold as low as $2,750, and in 1909 at $96,000. The value of seats always advances in a bull market and falls in a bear market, influenced by the degree of public speculation and the necessities of members.

The Exchange has always been strict about admitting applicants to membership, insisting upon an honorable record and a good business reputation. Some of the men who have helped make Stock Exchange history by their big operations were never members and could not have gained admittance. Members are suspended or expelled for infraction of the rules or for dishonorable conduct in business matters. There is a Committee on Business Conduct to watch over these things.

How Business Is Handled.

The Exchange opens at 9:30, trading begins at 10 and closes at 3, after which hour the "money crowd" gathers for the borrowing and lending of the money needed to carry securities.

Scattered about the room are posts bearing the names of different securities, and those Those who wish to buy bid for "100 at respective posts. Some have orders from customers or other brokers at fixed prices or at "the market," others are ready to trade for their own account.

Those who wish to buy, bid for "100 at 78½," "500 at 78¾," etc. Those wishing to sell offer "200 at 79," "100 at 78⅝," and so on. As soon as a trade is agreed upon a waiting messenger takes a memorandum of it to the representative of the ticker company on the floor and the quotation is sent out over the tickers to hundreds of brokerage houses and private individuals and is posted on the Stock Exchange board. Each post also has an indicator showing the lost quotation made.

Each broker makes a memorandum of his transactions and with whom made. In very active markets as soon as he has leisure after executing a number of orders, he seeks out the other party to the transaction and checks the item. In case of a misunderstanding a compromise is necessary, but this rarely occurs.

This personal comparison on the floor is often neglected, but the broker or house making a sale is required by the rules to compare the transaction at the office of the buyer not later than one hour after the close of the Exchange. This comparison is effected by an exchange of memorandum slips.

Each broker has a number, and when he is wanted at the door or at the rail, his number is flashed on the electric annunciator which occupies one side of the room. The lights behind these numbers are of different colors, signifying where the broker is wanted.

Sales may be made for "cash," which means for delivery on the day of sale; "regular," for delivery on the next business day; "three days," for delivery on the third business day, or on "buyer's and seller's options," which may run not less than four nor more than 60 days. Sales are often made "seller 30" or "seller 60" when the securities sold are not in New York, but are to come from another city or from abroad.

Brokers' deliveries of stock certificates sold must be made before 2:15 of the same day if "cash" or of the next day if "regular." When

the books of a corporation close for the payment of a dividend, the stock sells "ex-dividend" on the Exchange—that is, the amount of the dividend is deducted from the price of the stock. The dividend check goes to the holder of record of the stock certificate, but if the certificate has been endorsed in blank and sold to someone else, the brokers who have handled the transactions pass the dividend check along and it is credited to the present owner of the stock on the books of the brokerage house which is carrying the stock for him.

CHAPTER VIII

How Business Is Done on the Stock Exchange (Continued)

MOST of the methods of the Exchange are readily understood—in fact, they are little more than the most obviously convenient way of handling the purchase and sale of securities. There are, however, some parts of the necessary machinery that the public does not easily grasp. Among these are short sales, the borrowing and lending of stock certificates and the Stock Exchange Clearing-House.

Short Sales

The whole world is accustomed to sales of all sorts of goods for delivery some time in the future; yet when sales of stocks, grain or cotton are made in this way on an exchange, they are often stigmatized as a form of gambling. The very farmer who sells his own crop of standing wheat for delivery after it is harvested and threshed wil often be heard criti-

cising the practice of short-selling on the Chicago Board of Trade.

On the grain and cotton exchanges and the London Stock Exchange short-selling consists simply in the sale of contracts for the future delivery of the goods. It is the failure to grasp this idea that causes much confusion of mind on this subject. The short-seller of grain, cotton, or of stocks, in London, does not really sell those articles himself—he sells a contract for the delivery of the articles some time in the future. All the business is handled through responsible brokers, who make the contracts in their own names. Hence the contracts can be passed from hand to hand among the brokers just about as readily as so many dollar bills, and may be sold and resold any number of times.

For example, if you wish to sell short 5,000 bushels of May wheat, at 90 cents a bushel, you say, in effect, to your broker:

"I agree to furnish you, on or before the end of May, an acceptable contract for the delivery of 5,000 May wheat of standard quality at 90 cents. I believe I can buy such a contract from somebody else before that date for

less than 90 cents a bushel. If not, of course, I shall have to pay more; but in any event I will protect my agreement."

For your agreement the broker substitutes his own—since you are not known on the Exchange—and sells it at 90 cents in the open market. You protect him by a reasonable deposit of cash in his hands.

Short sales of stocks may be and sometimes are made on the New York Stock Exchange in exactly the same way, but the customary method is a slight variation of the above. Instead of delivering to the buyer a contract for the future delivery of the stock, your broker borrows the stock certificate from someone who has it on hand and delivers the certificate itself. The effect is substantially the same. Sooner or later you have to furnish your broker, in some way, with a certificate to be returned to the person from whom the broker has borrowed one. If you have the certificate—in your safe deposit box, or perhaps in another city—you get it at your leisure and turn it over to your broker. If you haven't the necessary certificate, then you will eventually have to instruct your broker to buy one for you in

the market—in other words, you "cover" your short sale by buying a certificate on the Exchange, which your broker can then return in place of the one he borrowed to sell for you.

So far as you are concerned, this is a sale for future delivery. The only difference is in the system by which the broker handles it. Your broker, having your agreement to supply the stock whenever he wants it, is safe in not only selling the stock, but in borrowing it from someone else and delivering it to the buyer. You are safe in entering into the agreement, for even though you may not have the stock yourself you know that you could at any time arrange with some other broker to supply it to your original broker in case he should want it, which rarely occurs. And in the end you close the whole deal by instructing your broker to buy the certificate in the market to fill your short sale, at a lower or higher price, according as your judgment has been correct or incorrect.

As to the usefulness of short-selling there can be no doubt. In order that the price of a stock may be kept as nearly as possible at its

true value, it should be possible for anybody to buy at a price below what he believes to be a just valuation or to sell at a price above that valuation. Without short-selling he could buy at any time, but he could not sell unless he happened to have the stock on hand. The result would be a one-sided market, such as is seen now in many stocks which are so scarce that it is impossible to borrow them for the purpose of short sales. And, of course, any amount of short-selling makes no permanent difference in the demand and supply.

Borrowing and Lending Stocks.

Since there are always some people short of most of the active stocks, a great many certificates have to be borrowed every day by the various brokers. There is usually no difficulty about this. The broker who has a lot of stock certificates in his vault takes no particular satisfaction in seeing them there. On the contrary, he usually puts them up with his bank and borrows as much money on them as he can, which is perhaps 70 per cent. of their market value, and he pays the current rate of interest for the use of the money. If another

broker wants to borrow some of them, broker No. 1 says:

"All right, I will put them up with you instead of with the bank, if you will lend me their full market value at the same rate of interest."

There are generally plenty of stock certificates in Wall Street, but to borrow money it is necessary to pay interest; hence it is the lender of stocks that pays interest to the borrower on their money value, which is just the opposite from what the novice usually supposes. What borrowing stocks really means is lending money on the stocks as security up to their full market value. No one would be willing to do that except the broker who wants the certificates to fill some of his short sales.

In this way a regular loan market arises for the borrowing and lending of stock certificates, and the rate of interest allowed on the money value of the stocks may be quoted differently for different issues, according as those particular certificates are scarce or plentiful in the Street. If the certificates of a stock are plentiful, the loan rate on that stock will usually be the same as for call money, but if they

are scarce the interest rate may be lower than the call money rate, or they may loan "flat"—that is, no interest at all is paid on the money which is loaned on the stocks as security—or even at a premium, which means that the usual order of things is reversed and the borrower of the stocks is obliged to pay something to get them.

All these details the broker handles, so that the process of short-selling so far as the customer is concerned is just as simple as that of trading on the long side. On the long side the customer buys first and sells later; on the short side he simply reverses the operation, selling first and buying later.

Nevertheless the public does very little short-selling. To most people it seems mysterious and they are a little afraid of it. If the market goes against them on the short side they are disturbed, while on the long side they are not much worried. "There is a bottom but no top," they sometimes say—which may be true theoretically, but not in actual practice. Also, the great majority of people are temperamental bulls and prefer to work on the bull side for that reason.

Professional and semi-professional traders operate just as freely on the short side as on the long and it would probably be a good thing for the market and for the public interest if the public could do the same; but that would require far more intellectual acuteness and detachment than the majority of persons are likely to attain.

Stock Exchange Clearing-House

Formerly every stock certificate sold was delivered by messenger, in exchange for a check for the value of the stock. This made a great deal of unnecessary work, but it was the tremendous value of checks that had to be issued every day that really compelled a change in methods. In 1892 the banks rebelled against issuing so many checks, a practice only rendered possible by extensive over-certification and the Exchange adopted the Clearing-House method, which had long been successfully used in Philadelphia, Boston and Chicago. This is an adaptation of the bank clearing-house system to the trade in stocks.

For example, Broker A has sold B 100 Reading for $75,000; B has sold 100 to C for $74,-

000; C has sold 100 to D for $74,500; and D has sold 100 to A for $75,250. There is evidently no reason why four different deliveries of 100 Reading should be made, accompanied by the issue of four checks for the full value of the stock in each case. The stock is back where it started from and all that is necessary is the issue of small checks to cover the differences in value. If the 100 Reading, instead of getting back to A had gone to E, it would only have been necessary to make one delivery of the stock, from A to E.

Extend this example over a large list of active stocks and you have the Stock Exchange Clearing-House. A force of clerks is employed and the system has been carefully worked out and improved by experience. Each broker sends in his clearance sheet and every trade is represented by a ticket. The tickets are distributed in boxes like mail in a post-office. Then all trades in each stock are listed on a sheet and examination shows what trades will balance each other and what deliveries will be necessary. On the following morning the various brokers are notified what deliveries they must make.

Loans of stocks, as explained above under short-selling, appear on the clearance sheets as sales, since the lender receives their full value just the same as though he had sold them. On the side of the borrower the transaction goes through the Clearing-House as a purchase.

The Clearing-House is surrounded by as much secrecy as possible so that information in regard to important purchases and sales may not leak out. Pratt, in The Work of Wall Street, gives the number of shares cleared in 1901 as 926,347,300, having a value of $77,853,500,000, and the number of share balances, which had to be delivered, as 134,395,000, having a value of $10,930,853,600. The great saving resulting from the system is obvious.

The number of shares traded in on the Exchange in 1901 was 265,944,659, while the number going through the Clearing-House was 926,347,300—a point which mystifies many even among those who consider themselves well informed on the methods of the Street. Since each trade is cleared by both the buyer and the seller, that makes the clearance double the shares traded in; and the remainder of the

excess is accounted for by the borrowing and lending of stocks, which as we have seen go through the Clearing-House just like purchases and sales.

The Consolidated Stock Exchange.

Some of the methods used on the Consolidated differ a little from those of the New York Stock Exchange. This organization resulted from the consolidation of a mining and an oil exchange, hence its name. In the 70's and 80's there was a big speculation on it in this class of securities, and when that died out the exchange took up trading in the same stocks listed on the New York Stock Exchange.

The quotations made on the bigger exchange are posted on the Consolidated and are the basis for trading there. Naturally this is not pleasing to the New York Stock Exchange, but the smaller institution has succeeded in making a place for itself and at present the business on it is about one-tenth that of the big exchange. It is, however, differently distributed. The business in some of the established speculative favorites, like U. S. Steel,

Anaconda, Smelting, or Reading, is usually more than one-tenth that of the primary market, while some of the inactive issues are rarely dealt in.

Most of the business is in lots of less than 50 shares. Settlements are made weekly instead of daily, so that the customer who closes his trade in the same week it is made escapes the payment of interest. The market for odd lots of the active stocks is about the same as on the big exchange, but for larger quantities or in the less active stocks execution is sometimes erratic, owing to the relative narrowness of the market.

Government of the Exchange.

The final authority on the New York Stock Exchange is the Governing Committee, which consists of a president and a treasurer elected annually and 40 members, 10 of whom are chosen each year. The governors are divided into various sub-committees—on arrangements, admissions, arbitration, commissions, constitution, finance, law, the stock list, the Clearing-House, etc.

In 1913, by an amendment to the Constitu-

tion, a committee on Business Conduct was created "to keep in touch with the course of prices listed on the Exchange, with the view of determining when improper transactions are being resorted to," and having the power "to examine into the dealings of any members, with respect to the above subjects." This is one of the steps taken in recent years to raise the standards of the business. One object of this committee is to prevent the execution of "matched orders," a subject which will be discussed in another chapter.

CHAPTER IX

Inside the Broker's Office

STOCK brokerage as a business origniated in England in the latter part of the seventeenth century, when the East India Company attracted a great deal of public attention. In the United States the business can scarcely be identified before 1790, although there were doubtless many individual cases before that date in which one person acted for another in the purchase or sale of stocks.

Before a sale of stock can be consummated the seller must find a buyer or the buyer find a seller. It would usually be a long and troublesome job for the buyer or seller to do this personally, so the work is turned over to some agent who is already in touch with many buyers and sellers. This agent is the broker, and for convenience the brokers have an exchange where they meet to compare buying and selling orders and adjust prices. Thus the Stock Exchange.

Each broker must have his place of business. A small broker, who does business principally for himself and for a few clients, may need only

deskroom, arranging with another broker, who has all the necessary machinery, to "clear" his transactions for him. But the active broker has to surround himself with clerks and bookkeepers and provide facilities for his customers to watch the market and place their orders promptly. This is the brokerage house as the public knows it.

Such a house has one or more members on the floor of the Exchange, to whom orders are telephoned and from whom reports of executions of the orders are received. It has one or more office partners, who oversee the work of the office and consult with customers. It has a "cage," containing the order clerk, cashier, margin clerk, delivery clerk, bookkeepers, etc. It has messenger boys to deliver stock certificates and checks to other brokers as may be necessary.

Most such houses provide a "customers' room" where quotations from all exchanges of which the house is a member are posted on a blackboard as fast as they come out on the tickers, and the principal newspapers and news services are kept on file. Some houses, however, even though doing a large business, do not like the customers' room and abolish it, doing business

with their clients over the telephone, telegraph, by letter, or by personal consultation. This is because an open customers' room is apt to attract a great many "chair warmers," who do very little business but make a nuisance of themselves by foolish conversation. Such traders may repel a better class of business men, and yet it is a disagreeable task to invite them to take their account elsewhere. Brokers are always glad to have strangers drop into their offices to glance over the market, but they naturally object to having their customers' rooms turned into lounging places for idlers.

The most important part of a broker's business usually comes in over the telephone and telegraph, although many mail orders are also received from out of town. Novices are sometimes surprised that the broker is willing to accept orders by telephone since this evidently gives a dishonest client the opportunity to repudiate the order if the market goes against him, by asserting that the order was misunderstood. But the average broker is a good judge of human nature and rarely permits a customer to get on his books who would be capable of such trickery.

The Handling of Orders

An account is opened with a broker by the depositing of a check. Theoretically some sort of introduction is supposed to be required, but a fair-sized check is usually a good introduction—although if the check was from an unknown person the broker might naturally wish to collect it before executing orders.

In this way the broker acts in the double capacity of banker or "pledgee," and agent in the execution of orders. Formerly many houses called themselves "Bankers and Brokers" in recognition of this double function, but that term became so widely used by bucketshops and nonmembers of the exchanges that it has been practically dropped by the better class of brokers.

The account having been opened, the customer is free to place orders. The house will, in nearly all cases, suggest suitable investments if desired, but in doing this, the broker accepts no responsibility. He merely gives his client the benefit of his judgment without in any sense guaranteeing it to be correct.

It is to be regretted that the broker is not usually as ready to tell his customer when to

sell as when to buy. He nearly always leaves the customer to select his own point for taking a profit or a loss, as the case may be. The principal reason for this is that the customer is usually much disgusted if his stock advances further after the broker has recommended that he take profits. That is unreasonable but it seems to be human nature. Also, the broker seems to feel that he has done all that can be expected of him if he has recommended a purchase that turns out well. So long as the customer has a profit in his open trade, the broker sees nothing to worry about.

This is unquestionably a wrong viewpoint. The proper closing of a trade is just as important as the making of it, and it is all the more necessary that the broker should watch this end of the transaction because the average customer is much more ready to buy than to sell.

The number of shares of any stock that the broker will be willing to buy or sell for the customer on his deposit depends entirely on the character of the stock selected. On many active stocks, having a good market, the broker will be satisfied with a deposit of $10 a share—though he will generally recommend that a larger margin

be carried. On other stocks, $20, $30 or $50 may be necessary to protect the broker from a possible loss, and still others he will not buy unless they are paid for in full.

If the customer's deposit is equal to $10 a share on the stock bought, a decline of ten "points" will evidently exhaust the deposit or margin and the customer must then either deposit more margin or sell the stock. Inexperienced traders often think that the broker might "carry" them a little below this "exhaust point," but the broker who attempts to do it is headed for certain financial ruin and is unsafe to do business with. There is only one safe way to handle a brokerage business and that is on a strictly cash basis.

Margins

The broker will always "call" his customer for more margin when the price of the stocks held begins to approach the limits of the customer's deposit—in fact, he is required by law to do that. If the customer does not respond or if, in a very active market, he cannot be reached in time, the broker has the right to protect himself by closing out the trade; and

to cover any possible legal complications on this point, the broker usually prints somewhere on his stationery the statement that all orders will be executed in accordance with customs of the New York Stock Exchange, or he may be even more explicit and say that he reserves the right to close trades without notice when margins are running out. The safe plan, of course, is for the customer to keep in his broker's hands ample funds to cover all contingencies.

The customer is the legal owner of all stocks he buys. The broker acts as his agent. If the broker faithfully carries out his customer's instructions, with such a degree of care and skill as may reasonably be expected of any expert and reliable broker, and in accordance with the customs of the exchange on which the order is executed, he has acquitted himself of all further responsibility. The result is "up to" the customer.

When the customer deposits only a part of the value of stocks bought, the broker lends him the rest. Then the broker, as a rule, takes the stock certificates to his bank and borrows as much as he can on them. Thus if the stock is bought for $80 a share, the customer's de-

posit may represent $10 of that, the broker may lend him another $10 a share, and the broker may borrow from his bank on the certificate as security the remaining $60, which in turn he also lends to the customer.

This is called rehypothecation. The customer hypothecates his stock with the broker and the broker rehypothecates it to the bank. A recent New York law requires that the broker shall not rehypothecate to the bank for more than the amount owed on the stock by the customer unless by the customer's express consent. It is therefore necessary for every active brokerage house to get the customers' consent to the rehypothecation of all stocks, regardless of the amount the broker is loaning the customer on them; for it would be a very difficult and laborious task for the broker to continually watch all his loans so as to avoid borrowing in any particular case more than he has loaned the customer. The customer readily gives his consent, since his interests are not affected.

The buyer of a stock is entitled to a certificate or certificates for the number of shares bought, but not to any particular certificates since all the certificates are alike, each representing

merely a certain share of the whole company. Hence the broker is not obliged to get back from his bank the exact certificate on which he originally borrowed money for his customer's use.

A customer will sometimes request his broker to use a certain amount of discretion in executing an order—for example, to buy at a certain price if the market looks right to the broker when that price is reached. The broker will hardly ever do this unless as personal favor to a friend, and even then he almost always has occasion to regret having been too accommodating, for the friend is pretty sure to feel some dissatisfaction—uttered or unexpressed, but too frequently uttered—with the broker's judgment. Most exchange members have an absolute rule that no discretionery orders will be accepted, and under any ordinary circumstances the house that accepts them will be regarded with suspicion.

Interest

The broker charges his customer interest for money loaned him just as a bank would. The rate of interest is usually an average of the rates the broker is paying for his various call and time loans, with a trifle added for the cost

of handling. Many brokers always charge 6 per cent.—or more if the current market rate is higher—on odd lots of stocks, because the trouble of handing a 10 share lot is just as great as that of handling 1,000 shares. A smaller rate of interest is credited to the customer on money lying idle in the broker's hands.

Since statements of accounts are usually rendered to the customer monthly, the interest charge, whether on the debit or the credit side, is compounded monthly. Hence when the customer borrows heavily from his broker the interest paid becomes a somewhat important item—another reason in favor of paying for stocks in full or keeping large margins.

The present scale of commissions on the New York Stock Exchange is as follows:

Stocks selling under $10............$7.50 per 100 shares
Stocks selling at $10 and under $125.15.00 per 100 shares
Stocks selling at $125 and upward..20.00 per 100 shares
Minimum commission $1.50
Liberty Bonds....25c for each $100 or fraction thereof
Other listed Bonds, $1.25 per $1,000, with minimum of $1.25.

On the selling side there are taxes of four cents a share. Also, the execution of buying and selling orders at the same moment is usually

$\frac{1}{8}$ or $\frac{1}{4}$ apart—since the "market" consists of a bid price and asked price. The buyer, for example, pays $81\frac{1}{4}$ while the seller gets only $81\frac{1}{8}$. Hence it may be said that the trader who is trying to make a profit in a stock selling above $10 really starts with a loss of not less than $46.50 or $56.50 per hundred shares, to which must be added interest when he is operating on the long side, and on the short side another $2 tax if the broker has to borrow the stock.

The short-seller does not have to pay interest, but if his stock sells ex-dividend while he is short of it he is charged with the amount of the dividend. This often puzzles the novice, but it is evident that the buyer of the stock must get his dividend from some source, and if it is a short sale the only possible source of the dividend is the short-seller.

CHAPTER X

Broker and Customer—The Unlisted Market

SINCE the broker acts as the customer's banker, holding for him securities and cash in large sums, in addition to being his agent in the execution of orders, it certainly behooves the customer to exercise the greatest care in the selection of a broker, just as much care as he would show in picking out a bank in which to make a large deposit.

It is a curious fact, however, that the average customer does not do this. The great numbers of people who deposit large sums and valuable securities with brokers in regard to whom they know almost nothing, and who are in many cases not members of any exchange, is a standing cause of wonder to the initiated. It seems that these people are doing business in a gambling spirit and look upon the risk of placing their good money in the hands of an unknown broker as merely a part of the gamble. It should be unnecessary to say that the person who approaches

Wall Street in that spirit is bound to lose. He might much better do his money and securities up in a neat bundle and present them to a Home for the Feeble Minded, where he stands a chance of eventually getting some indirect benefit out of them.

Brokers and Brokers

There are, of course, plenty of perfectly reliable brokers dealing in unlisted securities who are not members of any exchange—also plenty of unreliable ones. The novice, unless he has the means of informing himself fully in regard to the trustworthiness of brokers not members of exchanges, will do better to deal with such houses on a cash basis—that is, buying his securities for cash and taking them away with him, or selling for cash and immediately depositing in his bank the check which he receives.

Membership in a leading exchange is not of course, an absolute guarantee of the trustworthiness of a broker, but it is very strong evidence, since the principal exchanges make every possible effort to limit their membership to brokers of high standing. Many persons are ignorant of the fact that exchange members can and will

buy or sell unlisted securities for their customers to just as good advantage as houses which make a specialty of handling only unlisted securities.

When it comes to choosing among different exchange members the personal element enters largely into the situation. The majority of the customers of the long-established brokerage houses are acquainted with some member of the firm or with some employee holding a responsible position, with whom they consult from time to time personally or by telephone. Just how much good—or harm—the consultation does them depends entirely on the judgment of the person consulted. In past there have been many "customers' men" who were not above giving whatever advice they thought the customer would be most likely to act on, and unfortunately there are still a few of them left in spite of the fact that such a short-sighted policy is universally condemned by the better class of houses.

A broker who is known to be closely identified with "strong interests" or who has himself accumulated a fortune through operations in the market generally has a "following" of customers who hope to profit by his advice. Such advice is often valuable, but as a general rule not nearly

so valuable as the customer expects it to be, since even the best judges often go wrong. Moreover, the customer is much more ready to follow advice where it is wrong than when it is right. This is because, in order to make profits it is usually necessary to buy when the market looks weak and sell when it looks strong.

Before opening an account with any broker it is well to visit his place of business and form your own opinion as to his character and methods and to get a report on him from an unprejudiced source, such as a financial publication of high standing, or a New York bank or trust company.

Stock exchange methods of bookkeeping are not always apparent at a glance to a new customer who receives his monthly statement of account. Such statements differ in minor details but they are always substantially in the form of the example given herewith.

A Broker's Statement

The folio number in the upper right hand corner is for the convenience of the broker in referring to his own books. The account is debited with stocks bought and credited with stocks sold, credited with cash deposits and

debited with withdrawals, and the statement includes a memorandum of securities on hand, whether long or short.

In the example shown, we have first a statement of the condition of the account March 31. The customer was long 60 shares of various stocks. The customer's deposit with the broker was enough to pay for all these stocks, with the exception of $1,134.20, which was loaned him by the broker and therefore debited to his account. On April 1 two of his stocks paid dividends and the amount of the dividends was duly credited. (Note that this amount is credited when the dividend is actually received by the broker, not when the stocks sell ex-dividend on the exchange.)

April 17 the customer sold 10 A. R.—American Smelting—for $973.75. From this was deducted $1.25* commission and 40 cents taxes,

* It would now be $1.50.

PLEASE ACVISE WHITE, BLACK & CO. IMMEDIATELY IF THIS STATEMENT IS NOT CORRECT

Mr. A. Pickel **Folio 4356**

In account with WHITE, BLACK & CO., 1015 Wall St., New York.

					Dr.			Cr.		
1916	Bought	Sold	Description	Price	Amount	Days	Int.	Amount	Days	Int.
Mch. 31			Balance		$1,134.20	30	5.67			
Long	10		A. R.							
	10		Anac.							
	10		Ca. Pac.							
	10		A. F.							
	20		Alaska							
Apr. 1			Div. 10 A. F.					5	29	
			Div. 10 Ca. Pac.					25	29	.14
17		10	A. R.	97⅜				$972.10	13	2.11
										Bal. Int. 3.42
30			Int. @ 6%		3.42					
			To Balance					135.52		
					$1,137.62		5.67	$1,137.62		5.67
Apr. 30			Balance		$135.52					

Collateral as above. E. & O. E.

Broker's Statement of a Customer's Account.

and the customer was credited with the remainder, $972.10. He did not happen to make any purchases during the month. If he had he would have been debited with the amount paid for the stocks, plus commissions. The taxes do not apply on the buying side.

Interest is figured on each item from the date of entry to the end of the month. The interest is always first computed and entered in the interest columns at the rate of 6 per cent.; then if a higher or lower rate is charged the necessary change is made in the final interest item at the end of the month. Hence on his debit balance of $1,134.20 March 31 the customer was charged 6 per cent. interest for 30 days, to the end of April, or $5.67. On the $30 received as dividends April 1 he was credited interest for 29 days, or 14 cents. On the $972.10 received for the A. R. stock April 17 he was credited interest for 13 days, $2.11. The interest account was balanced by the entry "Bal. Int. $3.42" in the right hand column. This balances the two interest columns and the $3.42 is then debited to the customer.

The final result is a debit balance of $135.52 on April 30, which will be carried forward to

the next monthly statement, and he also has on hand "Collateral as above"—that is, 50 shares on various stocks. The abbreviation "E. & O. E." at the lower right hand corner means "Errors and Omissions Excepted."

The novice often expects to find on his statement the amount of his deposit with the broker plus or minus his profits or losses for the month, but the broker's books are not kept in that way and the customer has to figure out these items for himself. Most active operators keep a memorandum for that purpose.

Unlisted Securities

Trading was formerly permitted on the floor of the Stock Exchange in a number of securities which were not regularly listed—that is, the companies had not furnished to the exchange the information in regard to their business which would warrant the governors in giving the securities official sanction by listing them. Some of these stocks were among the most active, such as Amalgamated Copper, American Smelting & Refining, etc.

The exchange was, however, much criticized for permitting the trade in these securities to go

on and the "unlisted department" as it was called, was abolished in 1910, when most of these companies furnished the exchange with the necessary information and were duly listed.

The term unlisted securities is now used to apply to those which are not listed or traded on any exchange but are dealt in over the counters of investment houses. The Curb still has both listed and unlisted departments, of which more later.

The market for unlisted stocks is naturally not so "close" as that for listed securities. Various dealers stand ready to buy such stocks at one price and to sell at a somewhat higher price, but the difference between the "bid" price and the "asked" price is generally wider than in the case of listed stocks.

The broker who has an order to buy or sell a stock not listed on any exchange has to telephone around to the different dealers and find the best price at which his order can be executed. In the case of stocks of companies located in distant cities there is sometimes a better market there than in New York and quotations from that point are obtained over the broker's private wire or over the public wires, as may be necessary.

In some unlisted stocks a very active business is at times transacted, so that bid and asked quotations may be obtainable a point or even half a point apart, but on other securities it may be impossible to sell within five or ten points of the price at which a purchase could be made. Even if there is a close market at the moment, there is no knowing how long it may be maintained, since that depends very largely on the number of people who may happen to want to buy or sell at any time.

For this reason unlisted stocks do not, as a rule, afford a desirable medium for speculation. On the other hand, it is evident that the investor may sometimes get a better bargain in such stocks relatively to the normal market price, than he could get in most listed stocks. For example, the owner of an unlisted stock may be willing to sell at 110 or to buy more at 100. If he places an "open" or "G. T. C."—good till countermanded or executed—order with his broker to buy at 100 or sell at 110, he might eventually see both orders executed, in which case he would have a profit of ten points and would still be just where he started as regards the amount of the stock owned.

Trading in the unlisted stocks is, therefore, a very different proposition from doing business in the active listed stocks. An expert in a certain class of securities can often make large yearly profits by buying below the current market and selling above it. Many unlisted securities of a high investment grade do not fluctuate widely, except as the price swings back and forth between the bid and asked limits, so that trading of this kind may sometimes be carried on with only a very moderate risk.

Such trading is naturally pretty much confined to experts who have had long experience with some particular line of securities. The average investor is merely interested in getting a fair price when he wishes to buy or sell, since he depends mainly on the income yield from such stocks as a warrant for owning them. His broker can be depended on to execute orders at a fair price if he is not hurried too much. Some sacrifice usually has to be made to sell such stocks "at the market." Orders to buy or sell them are generally limited to a fixed price, which has to be lowered or raised in case it proves impossible to execute at that price.

In recent years there has been a great increase in the number of stocks which are dealt in over the counter. The public seems to imagine that these stocks are safer to own than the stocks on the exchange in which there is usually a big speculation. That is a false idea. The stock in which there is a big speculation may have more minor fluctuations, but as regards the wide movements it adjusts itself to the conditions more accurately than it would if it were unlisted.

CHAPTER XI

The Curb Market—Private Bankers

THE Curb Market consists of a rather loose organization of brokers who transact business in stocks in a roped-off section of Broad Street just below Exchange Place, a block from the New York Stock Exchange and about the same distance from the Consolidated Exchange. The Curb in its present form is over 35 years old; but there has always been trading on the curb ever since stocks began to be actively bought and sold. In fact, the New York Stock Exchange itself was originally a curb market, around the buttonwood tree at 68 Wall Street.

The necessity for a Curb Market in addition to the various stock exchanges is not always understood at a glance by the investor. It would seem as though the exchanges, in connection with the trading in unlisted stocks "over the counter," would afford ample opportunity for handling all kinds of business in stocks.

Nevertheless the Curb Market has its legitimate place in the machinery of Wall Street, as well as in other great financial centers.

Why the Curb Is Needed

Suppose, for example, that the investor has subscribed for ten of a new issue of bonds just being brought out by the underwriters, but owing to the fact that the issue was oversubscribed—which is nearly always the case—he obtained only two of the bonds. He wishes to buy more of the bonds at once, believing that the price will be higher after the bonds have been distributed to buyers, but since the bonds cannot yet be delivered he cannot make the purchase on any exchange or over the counter.

This is where the Curb Market steps in. The investor directs his broker to offer a certain price on the Curb for the bonds "when, as and if issued." Many other investors offer to buy or sell in the same way, so that a market price is established for the bonds some time before they are actually in existence. It occasionally happens that the bonds are not issued after all and in that event all the trans-

actions that have been made in them have to be cancelled.

Trading "when, as and if" is often carried to absurd extremes. A big automobile combination was recently proposed and trading in its stocks began on the Curb almost as soon as the idea had germinated in the minds of its sponsors and even before any name had been suggested for the corporation. In that instance the combination did not go through—owing, it was said, to the opposition of leading bankers—and all the trading in the stocks it might have issued had to be undone.

Even after the stock certificates of a new corporation have been issued they are not usually listed at once on the stock exchanges, because the new company, if an untried venture, cannot present to the exchanges an official statement definite enough to warrant listing. In the meantime there may be a great deal of buying and selling of the stocks, so much that it would be inconvenient and burdensome to handle it all over the counter. The situation is much simplified when all brokers having orders in such a stock gather in the Curb Market to execute them.

Even though a company may have been in existence a long time, its standing may not for one reason or another be satisfactory to the listing committee of the exchange, so that its stocks continue to be traded in on the Curb. There is no doubt about the usefulness of the Curb Market in such cases. People must have an opportunity to buy and sell all kinds of stocks.

The reason why the Curb Market stays on the street instead of housing itself more comfortably is that the constitution of the New York Stock Exchange prohibits its members from being represented on any other exchange, and at least 75 per cent. of the business on the Curb now originates with Stock Exchange houses. So the Curb stays outdoors and in only a partially organized condition.

The Curb Organization.

Previous to 1910 the Curb had no organization, except such as naturally resulted from necessity. Brokers on the Curb could not safely do business with persons whose responsibility was unknown to them, hence the trade was practically all handled by the same

group of brokers from day to day and their methods naturally fell into a sort of system.

In 1909 the Hughes Commission report criticized the Curb for obstructing the street, for being unorganized, for the frequency of manipulation there, and for sometimes dealing in securities nearly if not quite fraudulent. Partly as a result of this criticism the New York Curb Association was formed, with about 250 members paying annual dues of $100 each and with rules and regulations similar to those of the New York Stock Exchange. Listing requirements, however, were far from stringent, and it was soon found impossible to confine the trading to listed stocks, so that the Curb now has listed and unlisted departments as the Stock Exchange did formerly.

There is this difference, however, that the Curb Market is theoretically open to all who choose to trade there. But since strangers must be properly identified in order to guarantee the safety of dealing with them, the result is that the business is practically all done through the regular Curb brokers.

The Curb is one of the show places of New York and on an active day the crowd of howl-

ing, gesticulating brokers in the middle of the street is a novel and interesting sight. Curb brokerage houses rent offices overlooking the street, if possible, and orders are transmitted from the windows to the Curb by systems of signs, or sometimes by a bit of paper lowered by a string from a high window. Window space is naturally at a premium.

Issues Traded In

The issues traded in on the Curb are constantly changing. The best of them are usually listed on the Stock Exchange after their reliability has been reasonably demonstrated. Some are finally lodged in the hands of investors who hold them permanently, so that active trading in them dries up. Many of the companies represented are wafted away untimely to that bourne from which no traveller returns, for the prosaic reason that the enterprise has failed to pay. These are the issues found in nearly every investor's strong box which are preserved only for sentimental reasons, to be taken out and regarded mournfully from time to time and then laid tenderly back again. For some reason nobody ever

throws them away, even though the hole in the ground they represent may be flooded and moss-grown.

On the other hand, there are many sound investment securities traded in on the Curb, such as the Standard Oil stocks and numerous good mining and industrial securities.

The activity of the Curb Market fluctuates widely in different years. In 1899 Curb business became very large, but it fell off in later years until another Curb boom appeared in 1906. After that there was a long period of comparative dullness, but in 1915 and subsequent years business again rose to record-breaking proportions. On some days the number of shares changing hands was nearly equal to the transactions on the New York Stock Exchange—but, of course, their value was much less, since many of them have a low par value and an even lower market value.

Manipulation is much easier on the Curb than on the Exchange. It is not very difficult for the interests behind a Curb stock to mark it up or down, within reasonable limits, because the number of resting or "good-till-cancelled" orders may be very small. How-

ever, this very fact may give the genuine investor, who has a standing order in the market, an opportunity to buy at a low figure or sell at a high one, so that even this evil is not without some small compensations.

Wall Street has done much less toward complying with the recommendations of the Hughes Commission on the Curb than on the New York Stock Exchange. The cynics say that this is because the big Stock Exchange houses want to keep one place where they can carry on their manipulations substantially unhindered. But this is not a fair statement of the case. If people want to buy and sell stocks of uncertain value they are going to do it in some way, and indeed they have the right to do it, and it is the character of some of the stocks traded in on the Curb that makes manipulation possible rather than the methods by which the business is handled. If the Curb were to be turned into another exchange, with rigid listing requirements, the immediate result would be the formation of a new curb market to accommodate the business thus crowded out.

Private Bankers

On most of the Curb stocks the banks and trust companies do not care to lend money. Hence the New York Stock Exchange houses and the more conservative Curb brokers will not buy such stocks for their customers on margin. It is to be regretted that the Curb organization is unable to enforce this rule on all its members, since most of the stocks traded in are unsuited to margin operations. There are, however, a large number of private banking houses which undertake to buy Curb stocks for their customers on margins. These houses may call themselves "investment bankers," or "bankers and brokers," or "stock brokers," or by any other name; but since they make a business of lending money on stocks which will not be accepted as collateral by the banks they are in reality private bankers.

While it would be difficult to prove it, there can be little doubt that some of these houses do not actually carry all the stocks their customers are supposed to own. In other words, after buying stocks for a margin customer, the house soon takes a favorable opportunity of selling the same stocks for its own account.

This leaves the customer long and the house short of the same stocks, and it entirely obviates the difficulty which the house might have in getting the money to finance large purchases of stocks by its customers. In the meantime the customer is, of course, paying interest on the money he is supposed to be borrowing, which means profits to the house. When the customer sells his stocks the house at the same time or soon after covers its short sale of those stocks.

This operation is so near "bucketshopping" that it would be hairsplitting to attempt to discriminate, yet it is very difficult to detect and it would be still more difficult to stop it by legislation. The broker has executed his customer's orders correctly. The customer has received his due profits or suffered his loss as the case may be. What cause of complaint has he? If the broker saw fit to enter upon certain short contracts similar to his customer's purchase, that was the broker's affair. He might make or lose by those short sales, but in either case the customer is not affected—provided the broker remains solvent.

This provision is an important one, how-

ever, for the mortality among houses of this class is very high. They are the prostitutes of the Street, selling their honor for commissions and interest, and they are apt to live the short and hectic life of the prostitute. The intelligent part of the public avoids them as a pestilence, but there is always a careless and unintelligent public which wants to deal in Curb stocks on margain and is not discriminating in choosing its brokers.

The term "private banker" is about the most elastic in the realm of finance. Some private banking houses are nearly as strong as the Bank of England; others are capitalized solely upon the nerve of some ex-convict or graduate bucketshop man.

The great international banking houses are all private bankers—such as J. P. Morgan & Co., Kuhn, Loeb & Co., J. & W. Seligman & Co., Speyer & Co., etc. These houses are closely connected with the best investment bankers of other cities and they are frequently the representatives here of the leading firms or even the governments of Europe and other continents.

CHAPTER XII

The Promoter—Underwriting Syndicate

WITHOUT doubt the majority of the people of the United States regard the promoter as a "shark." That opinion is not wholly unreasonable, for a great many "sharks" have posed as promoters, but the business of the honest and legitimate promoter is one of the most useful of all occupations and is of very high value to the community. For that reason it is a rule highly paid.

The greatest advances in civilization are always made by some new combination of materials or resources or both. A new combination of this sort that will really work and produce the desired result is very hard to think up and still harder to put into practical operation.

When a new combination of materials results in some great improvement its effects are generally appreciated by the people and whatever profits the investor may realize are never begrudged him. Every one sees the advantage

of the electric light, for example, and is glad to see Mr. Edison make money out of it. But the immense value to the public of the ability to combine resources, to put capital, labor and materials together in such a way as to do necessary work more economically or to achieve some result previously impossible, is understood by only a few persons out of the multitude.

Why the Promoter Is Entitled to Big Profits

Suppose, for example, an inventor claims that he has discovered a method of making steel rails that will not break in any weather or under the heaviest loads. Others have money that they would gladly invest in the enterprise of making unbreakable rails. Skilled engineers know how to test the rails and investigate the process. Others own the coal and iron and other materials needed. There are railroads which would gladly buy the rails if satisfied that results were assured, but none of these people know the others and *none of them would believe what any one of the others might claim* in regard to the enterprise.

Under such conditions the public is a long

way from getting the benefit of the unbreakable rails. The inventor might die a poor and saddened man, the investors might never get more than savings bank interest on their money, the engineer might be out of a job, the coal and iron might continue to lie worthless in the ground, the railroads might continue to suffer from accidents, many passengers might be killed and much property destroyed—unless somebody appeared who could combine all the separate elements and *make the rails.*

But suppose a well-known banking house, which by a half century of honest and intelligent dealing has gained the confidence of all parties, takes the matter up, brings all the necessary experts together, plans a location where the materials are easy of access, forms the corporation and sells the securities to its clients and to the public, turns out the rails and supplies them to the roads. All parties believe what the bankers say because they know that the bankers' most valuable asset is reliability.

It is evident that this banking house has rendered an exceedingly valuable service to the public and a service which very few are in a

position to perform successfully. It is entitled to a correspondingly liberal remuneration for its services in the promotion. And the same would of course apply to the individual promoter.

Perhaps mankind may some day evolve a better and more economical way of making these necessary combinations of men, money and materials, which will eliminate the very large profits often gained by those individuals who are in a position to handle such promotions; but until that time comes we shall have to admit that the promoter earns his pay, large though it may sometimes be. And promotion will continue to be the principal function of our greatest private banking houses.

This class of bankers also do a genuine banking business. They make all sorts of loans, buy and sell commercial paper and many of them deal in foreign exchange. They often carry the accounts of our greatest corporations, which in many cases they have been influential in establishing. They buy and sell investment securities and underwrite new issues of stocks and bonds, promote industrial companies, handle the reorganization of insolvent railroads.

A few of the biggest of these private banking houses have enormous financial power and influence. They use it chiefly for the financial benefit of themselves and their associates and clients. Yet since the whole country must stand or fall together, their general attitude toward business must necessarily be constructive. In a broad way, they cannot harm the rest of the country without harming themselves, because their interests are so widely distributed. In times of panic the country has again and again turned to these houses to save the day. They have been sometimes charged with producing panics for their own benefit but the accusation is absurd. They would always profit far more from prosperity than from panic and depression.

But there is no magic about the term "private bankers." It may have everything behind it—or nothing.

Underwriting.

The successful distribution of new securities among investors is not an easy matter. Under ordinary conditions it is not easy to sell a man anything. He is cautious and fearful about

letting go of his money. And when all he is getting in return for it is a piece of paper carrying certain engraved promises of greater or less significance, he becomes still more cautious.

For this reason the prime necessity in selling securities is the confidence of the public, and in order to sell a large issue of stocks or bonds it is necessary to get in touch with numerous banking houses which have the confidence of their clients. Each of these houses must of course be paid for its services in some way, and this is usually accomplished through the process of underwriting.

For example, a big railroad wishes to sell $100,000,000 bonds to get the money for needed extensions and improvements. One of the leading firms of private bankers which is accustomed to handle such business for the road takes charge of the financing, charging a commission for its services. This firm then forms a syndicate of other bankers, dealers in investments, and brokerage houses. Each member of the syndicate agrees to take a certain number of the bonds and pay for them at, let us say, 97, if necessary—that is, if they are not

sold to investors direct.

The bonds are then issued and offered to the public at, perhaps, 99. The bonds are advertised in the newspapers and financial publications and the various members of the syndicate send out circulars to their clients describing and recommending the bonds. If conditions are favorable the bonds may all be sold to investors and the syndicate receives its profit of $20 on each $1,000 bond (less expenses) for its services in selling the bonds and also for insuring the sale of them in advance.

If only half the bonds are sold to investors, then the members of the syndicate are called upon to take the rest at the agreed price of 97. They may later be able to sell them at 99 or even higher, but under some conditions they might have to carry the bonds for a considerable time or even to sell them at less than the syndicate.

A number of the leading private banking houses are so strongly intrenched in the confidence of the public and of other investment dealers that the success of any offering they consent to undertake is assured from the start. In fact, the smaller investment houses which

are usually invited to join syndicates being formed by these leaders hardly feel at liberty to decline, even though in some special instance they might prefer to stay out; for if they refuse to join in one syndicate they are very likely to be left out of the others which will certainly follow, and this they cannot afford.

There are many issues of securities which leading private bankers do not care to handle, either because the issue is too small to yield enough profit or because its safety does not conform to their high standards. Small issues are handled by smaller houses, which may be of equal standing with the great leaders of the Street, only not so widely known.

Speculative issues are handled by other houses, each house taking its character and standing from the securities which it sponsors. The more doubtful the enterprise the larger the profits it has to promise in order to attract buyers, and as a general rule the greater the promises the greater the risks.

Individual Promoters

Often these speculative issues are handled by individual promoters, whc may own the en-

terprise themselves or may receive a commission of 10 or 15 per cent. for selling the securities. The ordinary method is to obtain a list of possible investors and mail out large numbers of prospectuses describing the future of the enterprise in glowing terms. This is an expensive method of promotion, since most of the circulars go into the waste-baskets of the recipients. Even under favorable conditions securities can hardly ever be sold in this way at a cost of less than one-fourth of the cash received, and sometimes practically all the receipts are absorbed in expenses and commissions, resulting in the early death of the company, even though the scheme might have been meritorious enough to succeed if enough money could have been cheaply obtained from the public.

Very few of these individual promoters start out with the deliberate intention of being swindlers, although they are pretty sure to be called that if for any reason whatever the enterprise does not succeed. Most of them are the victims of a mistaken enthusiasm—but of course that fact does not help the investor who has lost his money through them.

Some, however, are merly "fakes." They issue attractive prospectuses regardless of the actual prospects of the company—in fact the company is nothing but a legal peg on which to hang their glittering rhetoric. Their only anxiety is to get the money of "suckers" by outwitting the law. The difficulties in the way of doing this increase year by year. More and more stringent laws have been passed and they are better enforced than formerly. But the evil is not entirely extinguished and perhaps never will be.

The Post Office Department of the Federal Government has been active in recent years in checking the operations of fake promoters, since it is almost necessary for them to operate by mail. The Post Office has an almost autocratic power in dealing with suspects of this class, and it has probably made some mistakes; yet on the whole it has been of very great service in terminating the careers of swindlers.

The newspapers have also become much more careful in accepting the advertising of promoters. Some years ago it was purely a case of *caveat emptor* for the reader of finan-

cial advertising—or perhaps *sauve qui peut* would be an even more apt expression; but most of the papers now make a sincere effort to shut out financial swindlers from their columns, and many of them even exclude all security issues of a highly speculative character.

A sort of detective agency is maintained in Wall Street for the benefit of newspapers, financial publications and others who may need "inside information" in regard to the character of the thousands of people who are doing business in the financial district. Furnishing accurate information of this kind is a very large contract and in the nature of the case it cannot aways be thorough-going. Mistakes are sometimes made and some injustice doubtless results—for when once the man who is trying to do business in Wall Street gets "a can tied to his tail" he might as well shut up shop or change his name—but on the whole the effect has been good.

The sale of doubtful securities by promoters depends upon the gambling spirit among their patrons and therefore it is not likely that it can ever be entirely stopped. Perhaps there was a time when the buyer of such stocks was really

carried away by the promises of the prospectus, but there are few such instances now. The buyer fully realizes that he is taking a "long shot," but he figures that if one out of ten of these enterprises succeeds the profits may be large enough to cover the nine losses.

It is doubtless unnecessary to add that this is not so. Not one out of a hundred of these highly "promising" promotions ever "makes good." More than that have merit—perhaps half of them have merit, to a greater or less degree—but it takes something besides a good idea to make a business success. Insufficient capital and poor management are usually the rocks on which these enterprises founder.

CHAPTER XIII

Distribution of News and Quotations

A MOST important and interesting part of the machinery of Wall Street is that which collects from all over the world the items of news which may affect the markets and distributes them to brokers and investors, and then collects on the floors of the several exchanges the quotations resulting from the orders constantly flowing in and distributes these quotations to the public.

The men who have large interests at stake in the markets cannot, of course, wait for the newspapers. They and the brokers who serve them make every effort to get each item of news by telephone or telegraph at the earliest possible moment.

Happenings on the floors of the exchanges are reported by telephone or sometimes by written memoranda dispatched by messengers. These messages are quickly typed and filed in customers' rooms. When the news is very important it is transmitted by telephone or tele-

graph to the broker's clients who are not at the broker's office.

Important news from all over the world is also frequently forwarded by wire or cable, in order to get it to its destination ahead of the regular news channels. Such an event as a decision of the Supreme Court, for example, is likely to be felt on the floor of the Stock Exchange in five minutes after its purport can be gathered by representatives on the spot. In at least one instance a nervous and overwrought watcher did not wait long enough to get an understanding of a court decision and forwarded an incorrect message which caused a considerable slump on the Exchange before it could be corrected.

The News Agencies

It is only in regard to news of special importance that private messages are employed. The great bulk of the news which may affect the markets is gathered by the two Wall Street news agencies—Dow, Jones & Co. and the New York News Bureau—with the aid of the Associated Press, foreign news agencies, local news organizations in various American cities, and

special representatives. Very little worthy of note escapes these Argus-eyed organizations.

To save the time required to duplicate or print and distribute these items, they are first sent out in condensed form over the "page printer," or news ticker, a complicated little electrically driven machine somewhat similar to the typewriter. These printers are found in nearly all brokerage offices, bond houses, banks, etc., and even in restaurants or saloons which have the sort of patronage to warrant them. All are worked by electrical wires connected with a single central operator. Each machine contains a roll of paper about six inches wide on which the messages are printed out with what seems painful slowness to the feverish speculator. As each line is finished the machine automatically shoves up the paper half an inch and begins on a new line. Though very ingenious and usually reliable, they are subject to peculiar diseases of their own, so that the cry "ticker out" often goes up just at the most exciting moment.

The next step of the news agency is to set up and print the news items in a more elaborate form of the "news slips," or sheets of paper

about the size of the ordinary book. These slips are delivered to subscribers in bunches by boys about every half hour. By the end of the day the amount of reading matter sent out in this way is equal to that contained in the average newspaper. It is very comprehensive and contains many items of general interest not directly connected with the markets.

By these means that part of the public which is interested is kept constantly informed of the development of events and thousands of more or less acute minds are continually digesting the miscellaneous mass and transmitting it into orders to buy or sell this or that security or commodity.

Since the first readers of all this news are for the most part speculators, they are most interested, not in the final effect of the developments recorded, but in what other speculators will think and do—for that will control the immediate movements of prices. It is to this problem that they apply their reasoning powers and the results are sometimes almost ludicrous.

For example, the market has a quick break. Speculators rush to the page printers to see

what caused the decline. After a few minutes the news comes out on the printers. Then the mental acrobatics begin. Some are alarmed by the news and sell some of their stocks. Another reasons:

"Ah! They have sold the market down on this news and have all got short. When they start to cover, prices will rally. Buy a hundred Steel!"

Still others may say, "This selling is genuine liquidation. Room traders have bought on the break, expecting a rally. They are all long and when they try to close out they will find a poor market on which to sell. The real decline hasn't started yet."

There is probably no place in the world where so much topsy-turvy reasoning can be observed as in the customers' room of a speculative brokerage house.

But the operations of these day-to-day speculators have but little if any permanent effect on prices. The broader movements of the market are made by that class which is sometimes called "speculative investors," who act more deliberately and form their opinions upon a careful study of the whole situation. Any

one investor is likely to be frequently mistaken but the combined judgment of all rarely goes far astray. Hence the level of prices, as a rule, pretty closely represents the balance of chances in regard to the various uncertainties which are at any moment overhanging the market.

Sending Out Quotations

As the thousands of orders which spring directly or indirectly from the accumulation of news flow into the exchange, their effect is recorded in purchases and sales and in a few minutes the return flow of the quotations follows. The trading at the various posts on the Stock Exchange is constantly watched by reporters who record the quantities and prices of the transactions and forward them by messengers to the telegraph operators representing the two stock ticker companies, who have stations in the exchange.

One of the ticker companies serves Stock Exchange members only, and the other serves any subscribers located where they can be reached by its wires—with the proviso that every subscriber must be endorsed by the Stock Exchange Committee having charge of the matter before a ticker can be installed in his

office. This is for the purpose of preventing the use of the quotations by bucketshops. There is no difference of importance in the service furnished by the two companies.

The stock tickers, like the page printers, are electrically connected with a central operator. Each ticker emits a narrow ribbon of paper bearing abbreviations representing the various stocks followed by the amount of each sale and the price. For example, "A. 300. 99¾" signifies that 300 shares of Atchison common have been sold at 99¾, and so on.

In addition to the two systems of tickers which carry quotations from the New York Stock Exchange there are tickers for the Consolidated Stock Exchange, for cotton, for coffee, for grain and provisions (from the Chicago Board of Trade and also from the New York Produce Exchange), for unlisted securities and for bonds. A score of cities outside New York have ticker services of their own.

In quiet markets the ticker often remains motionless for minutes at a time, but in busy times it has hard work to keep up with the market. After choking and sputtering at its best it frequently falls behind five, ten or more minutes. In a wild market this is decidedly

troublesome, for the operator who places his order to buy when his stock is selling at 90 according to the ticker may find that it was at that moment really selling at 93 on the floor. No complete remedy for this difficulty is in sight, for no mechanical device could keep up with the lightning fluctuations that sometimes occur in excited markets.

For the convenience of customers, brokers have the prices as they come out on the tickers posted on a blackboard. Formerly a few brokers attempted to post the amount of each sale also, but with the bigger markets of recent years it is doubtful if that is now done anywhere.

Many facetious nicknames are given by customers of brokerage houses to the different stocks, and these are often derived from the abbreviation used for the stock. Missouri Pacific is almost invariably known as "Mop," U. S. Steel sinking fund bonds are often called "Sinkers," etc. During the sensational advance in Crucible Steel in 1915 it was called in one office "Cruci-Bull," but in the decline of the next spring this was changed to "Crucify." Almost every broker's office in busy times contains some wit whose chief object

in life seems to be to entertain himself and the other customers.

Many watches in the Street are set by the stock ticker. Stock certificates must be delivered by 2:15 p. m. and this rule is very strictly enforced. A little before 2:15 the ticker prints "Time" and after a series of preliminary dots prints 2:15 p. m. at the exact second.

London Methods

The Wall Street news and quotation service is superior to any other in the world in the promptness and completeness of its operation. The London stock tickers do not attempt to print the price of each sale nor the quantity sold. They merely give at intervals the "bid and asked" quotations on each stock. The American stock trader in London feels as though he had no information about the market worth mentioning with only these meager figures to go upon.

Moreover, London quotations for American stocks are in dollars at the fixed rate of $5 to the pound sterling, and this has to be corrected by the current rate of exchange before the American visitor knows how his stock is selling in New York.

The New York page printers and news slips give the London quotations for the principal American stocks each morning, quoting both the London figure and the New York equivalent at the current rate of exchange.

Although the London Stock Exchange nominally closes at 3 p. m., which is equivalent to 10 a. m. at New York, the hour when the New York exchange opens, trading in Americans is usually continued in London until 4 and in active markets it may be kept up on the curb there until 8, when the New York exchange closes. New York, however, has to rise early to trade at the London opening. Brokers and their most enthusiastic customers sometimes make the sacrifice on the morning after some very important event, such as the Presidential election of 1896.

The London 2 p. m. quotations are posted in New York soon after 9 a. m., so the customer finds them there when he arrives at the broker's office. Formerly they had considerable influence on the opening at New York, but with the growth of the New York market and the great extension in the number of securities dealt in, London no longer has any great significance for us in this particular.

Arbitrage dealers watch London closely, but they get their own quotations by cable. Arbitrage means buying in one place and selling in another in order to take advantage of a difference in prices. There were formerly some arbitrage operations in stocks between American cities, and they still take place between Toronto and the New York Curb; but the term is almost confined to operations between New York and London, so far as stocks are concerned. In grain, arbitrage is constant between New York and Chicago, Chicago and Minneapolis, Chicago and St. Louis, etc., and it is frequent in cotton between New York and New Orleans.

The Wall Street ticker and news service has come to stand for "gambling" in the minds of many people, and there can be no doubt that it does tend to encourage operations in stocks, grain and cotton which are gambling in the sense that the would-be speculator is taking a chance on something he knows little about. As usual in such matters, a certain class of short-sighted reformers think the remedy lies in taking an ax and breaking up the tickers.

But the whole question goes deep into our economic and business system. In fact, it

reaches back to the very foundation of our Government itself. If we still believe it to be a self-evident truth that the right to life, liberty and the pursuit of happiness is really "inalienable," we can hardly forbid our citizens to operate or read tickers, or to buy and sell any legitimate article that they want to buy and sell.

The legal principle that certain acts may be prohibited as "contrary to public policy" has been mightily stretched in recent years, but it hardly covers establishing guardianship over persons, otherwise legally competent, who cannot tell which way the market is going.

Our economic system is haphazard enough and the improvement of it is a consummation most devoutly to be wished, but that is not to be safely accomplished by the light-hearted destruction of methods developed by many years of experience to meet conditions as they now exist. Until we can plan something better to take the place of the ticker and all it represents, we must perforce let it continue to tick.

CHAPTER XIV

Theory of Speculation—Speculative Terms

THERE have been numerous theories of speculation, some called "scientific" and some not dignified by that term. The central idea of nearly all these theories is that the market always represents a sort of contest between investors, of whom the most influential are large capitalists, and closely connected with the great banking interests, and speculators, including the pools, the big individual plungers and the public.

It must be borne in mind that in the stock market it is dollars that count, not individuals; that is, one man with $1,000,000 to use in the market has just as much effect on prices as 1,000 men with $1,000 each. Hence a few very large capitalists may easily over-balance, under ordinary conditions, all that part of the speculative public, which is operating in the market at the moment. Moreover, $1,000 used as a ten-point margin has ten times as much effect

as $1,000 which is used to pay in full for a stock selling at $100.

Hence, small investors, even though they may be very numerous, do not usually have much influence of the immediate movements of prices. The main contest is between the big investors—who might as well be called speculators, except that they can always command money or credit enough to pay for their stocks in full if necessary—and the other class of speculators, who will take a loss if the market goes against them far enough.

So the market goes through a series of "cycles," or "minor swings," in which the heavyweight interests, which are at the time more or less in control of prices, buy, during and after a decline, from the lighter speculators who can be scared into selling, and sell at a profit, during and after an advance, to the same or new lightweight speculators, who become enthusiastic enough to buy.

These minor swings occur within and subordinate to the broad movements of prices, which are based on investment values. That is, when the investment value of stocks is increasing, the upward "leg" of the minor swing will be longer than the downward leg, and

when investment values are falling the reverse will be true.

In this way the "technical situation is created. The technical situation is strong when most of the floating supply of stocks—or of a stock—is held by people who will not sell on declines, and it is weak when a large part of the floating supply is in "weak hands," or in the hands of those who will sell on a decline—that is "the public," as the term is used in Wall Street parlance.

Manipulation

The minor swing, which may last anywhere from a week to several months, is attributed by most people to manipulation—a term loosely used to mean a movement of prices which has no connection with investment values, and is brought about by the operations of controlling interests. It would be more accurate to say that the minor swing is nearly always accompanied by manipulation; for the real cause of the swing is that the speculative public generally buys high and sells low. No amount of manipulation could compel outside speculators to do this. They do it because they are "built that way."

Manipulation, however, is always going on, within limits, in any active market. When strong interests have bought up the floating supply of a stock which they believe to be relatively low, compared with its value, so that very little stock is offered near current prices, it is perfectly natural for them to bid up the price and try to get a following. After they think the stock has advanced as far as it is entitled to go or farther and they have sold out and perhaps gone short a little, it is quite natural for them to offer the price down to see whether the holders of the stock will sell on declines. That is manipulation. It may be carried on over a range of one point or—in a few instances—a hundred points. The principle is the same.

The frequenter of speculative brokerage houses is likely to hear something about "wash sales" and "matched orders." Wash—or fictitious—sales are a thing of the past, not now tolerated by any legitimate exchange, though still possible, perhaps, on the Curb. Matched orders are prevented so far as possible, but cannot be entirely suppressed. For example, a big operator gives one broker an order to sell

S. O. S. stock in specified quantities on a scale up from the current market; then he distributes among other brokers orders to buy S. O. S. The result is an appearance of great activity in S. O. S. at rising prices, although nothing may really be done except what this one operator is doing with himself. His object is to attract other buyers to S. O. S. The brokers who handle the orders may suspect what is going on, but they have no way of proving it, since every broker must, of course, keep secret the source of his orders.

Effect of Short Interest

The manner of selling stocks short has been previously explained. "Shorts" are proverbially timid. Most of them work for immediate profits and they "run to cover" when prices turn strong. This fact is a great help to manipulators, who are thus in many cases able to get the market higher than they otherwise could, by bidding up the price and "scaring in the shorts." On the other hand, the shorts often support prices by taking their profits after a sharp decline.

Stop Orders

Another help to the manipulator is the "stop order," which is an order to buy at a certain

price *above* the market or to sell at a price *below* the market. This sounds silly to the novice, but the purpose is to prevent a trade from running into a bad loss or to keep a trade from showing any loss at all after it has shown a fair profit. When stop orders are found in the market, any manipulator working on the bear side will naturally try to depress the price enough to reach them. When his customer's margin is in danger of exhaustion, the broker has to put in stop orders in order to protect himself from loss.

Puts and Calls

"Puts and Calls," or "Privileges" are somewhat similar to options in real estate. If Reading is selling at 90, Mr. A. pays Mr. B. $100, for example, for a contract to take 100 Reading at 85 at any time within 30 days. This is a "put"—A buys the put, B sells it. Then if A buys Reading at 87, his loss is strictly limited to two points, even though Reading may drop to 50, for he has a market at 85 at any time within 30 days. On the other side, if B sold to A a contract to sell A 100 Reading at 94 at any time within 30 days, that would be a call. A could call for the 100 Reading at 94 when-

ever he wanted it within the time limit. So if Reading advanced to 100, A would have six points profit without having invested anything except the cost of the call.

These privileges also look absurd to the ordinary observer, because A pays something for the privilege of buying *above* the market or selling *below* the market. Nevertheless, there are conditions under which they may be used very profitably by an expert.

Buying on Instalments

So much has been said against the dangers of margin trading that a substitute has been devised and has become very popular; namely, buying stocks on instalments. The buyer enters into an agreement with his broker to pay for his purchase of stock, part down and the balance monthly. The broker buys it and carries it for his customer until paid for in full.

So far as New York Stock Exchange houses are concerned, this is really a purchase on margin, for the broker retains the right to close out his customer's account to protect himself if necessary. The only difference is that the

broker demands a first payment large enough to make that unpleasant possibility exceedingly improbable. Houses not members of the Exchange, however, are free to make a contract with the customer not to sell the stock even if the price should decline below the point to which it is protected by the first payment, and some of them do make that contract. So far, since this practice came into vogue, they have not been called upon to go through a panic like that of May, 1901, or November, 1907. It is perfectly evident that the strength of the contract depends entirely on the strength of the brokerage house which makes it.

It will be noted that the broker, under this instalment contract, does not have to deliver any stock for months to come. In practice, if he is not a member of the Exchange, he can buy the stock whenever he gets ready. This leaves a loop-hole for "bucketing"—that is, for not buying the stock at all—but since the broker agrees not to sell the stock so long as the customer keeps up his instalment payments, there is little inducement to bucket the order. A more serious danger is that a fraudulent broker might silently fade away, taking the customer's money with him.

Discretionary Accounts

Legitimate brokers will rarely if ever accept discretionary orders, and most of them will not accept accounts which are to be managed by any other person, except the principal. This has checked the business of handling accounts for other people which was formerly carried on to a limited extent.

The timid novice is sometimes attracted by the idea that some "expert" can handle his account better than he can—especially after he has bungled matters for himself—but those experts who can really do it are usually busy handling their own accounts. Finding the exception is like looking for a needle in a haymow, and much more costly.

Market Letters

It is a noticeable fact that the higher the standing of a broker the less definite and emphatic are his market letters. Combining the business of the broker and the market adviser is decidedly difficult. The broker is generally too close to the market to see it in perspective.

In a study of the market letters of twenty leading brokerage houses, members of the New York Stock Exchange, I found that over a

period of several months they averaged a correct judgment of the trend of the market considerably more than half of the time. That is all that should be expected, but the novice often expects more and is disappointed.

It is in Wall Street that economic laws find their most accurate and responsive expression, and it has been the experience of mankind that tampering with economic law is generally costly. Not that there is anything sacred about economic law. It is simply the best method we have found so far of adjusting the business of life to the circumstances under which it has to be carried on. But the mere fact that this process of adjustment has been going on for centuries makes the wisdom of sudden or sweeping changes very doubtful.

The Wall Street of 1950 will undoubtedly be as far ahead of to-day as to-day is ahead of the Wall Street of the Civil War, but the change must come slowly and naturally, by well considered legislation and improvements in banking practice. There is no piece of the machinery which could be taken out and thrown away, because each piece has been fashioned by practice to meet some real demand.